

Case 15-2

Falcon, Inc.

It was January 2005, and Lee Morgan, CEO of Falcon, Inc., was getting ready to review the performance of Falcon's subsidiaries and to allocate its bonus pool. In recent years, this exercise had become a challenge for Morgan because of rising complaints from several subsidiaries regarding the performance evaluation system (PES) at Falcon. Morgan called in John Tracey, Falcon's controller, and had the following conversation with him:

Morgan (CEO): John, I guess it is time for us to take another look at our PES. Yoshi Takada [manager of Japanese subsidiary] has been complaining that it is unfair to evaluate all subsidiaries by the same yardstick.

Tracey (Controller): But fairness was perhaps the most important consideration when I designed the PES back in 1993. We hold each subsidiary manager, domestic and foreign, responsible for budgeted U.S. dollars profit, which allows us to achieve the corporate profitability goals.

Morgan (CEO): Takada's contention is that his unit's value added comes from its low-cost production. He feels that because he sells mostly to discounters and builder channels in the U.S., the price competition is severe, and profit margins are rather low.

Tracey (Controller): That's true. But it's a huge market, and Takada has exclusive rights from Falcon to cater to that market in the U.S.

Morgan (CEO): Steve Bogage [manager of Danish subsidiary] was suggesting managers should be rewarded using ROI [return on investment] since it is a comprehensive measure that incorporates not just the profitability but also the investments we make in the subsidiaries.

Tracey (Controller): We could consider that but you know the many limitations of ROI as a performance metric.

Morgan (CEO): Alphonso Canella [manager of Mexican subsidiary] has suggested that we track the budgets using the same exchange rate that we use in setting them.

Tracey (Controller): In that case, who should assume the responsibility for changes in the exchange rate?

- Morgan (CEO):** That's his point. He feels we penalize foreign managers by holding them responsible for dollar profitability when they cannot control the exchange-rate fluctuations.
- Tracey (Controller):** That's nonsense! Who else can determine the sourcing, supplying, and pricing strategies better than the subsidiary managers? We already manage the transactions and translation risks at the headquarters. Shouldn't they manage the operating part of the foreign exchange risk?
- Morgan (CEO):** Yes, I guess. We've always maintained that foreign subsidiary managers need to deal with the economic effects of the exchange-rate changes in making strategic and tactical decisions.
- Tracey (Controller):** Moreover, most of our stockholders are based in the U.S. Maximizing dollar returns to them should be our top priority!
- Morgan (CEO):** But Takada was complaining that the strengthening yen hurts his margins.
- Tracey (Controller):** That's been his alibi every year. Ever since he assumed the responsibility of Japanese operations in 1999, Takada has been clamoring for higher bonuses, despite his unit's unsatisfactory performance.
- Morgan (CEO):** But why should exchange-rate changes matter that much? I recall from my college economics course that purchasing power parity will take care of exchange-rate changes. In other words, inflation and the foreign exchange rate offset each other, leaving managerial performance unaffected by the exchange-rate movements.
- Tracey (Controller):** True, but that happens only in the long run. In the short run, exchange-rate movement might not fully reflect the differences in the inflation rates between the two countries [see Appendix A].
- Morgan (CEO):** So what should we do about that, John?
- Tracey (Controller):** Maybe we need to make appropriate adjustments to the budgets at the time of tracking them.
- Morgan (CEO):** Should we deemphasize financial aspects in our PES and institute new measures, such as market share, that Bogage has suggested on numerous occasions?
- Tracey (Controller):** If we incorporate the wish of each subsidiary manager in the PES, we will need a different system for each manager!

Global Appliance Industry²

As a result of mergers and acquisitions in the past three decades, the home appliance industry in 2004 had fewer than ten companies that together controlled about 50 percent of the global market. Some of the global players in the industry included Electrolux (Sweden), General Electric (U.S.), Maytag (U.S.), Whirlpool (U.S.), Matsushita (Japan), and Bosch-Siemens (Germany). The remaining 50 percent of the market was in the hands of country-focused competitors. The overall industry grew at a very slow pace, making competition among players very fierce. Growth for a particular company came mainly from acquisitions or from stealing a competitor's market share.

There were significant economies of scale in the manufacture of components, such as compressors and motors that were a critical part of home appliances. Improvements in component design were essential in enhancing the functionality of home appliances in areas such as energy efficiency, noise control, and water consumption. The three major segments in the home appliance industry were the low-price segment (where several eastern European and Chinese companies, and private label suppliers, competed), a mid-price segment (where Electrolux competed), and a very high-price segment (where Whirlpool's KitchenAid subsidiary and Maytag positioned several products). The distributors of home appliances in the U.S. consisted of major retailers (Sears, JCPenney, etc.), appliance stores, discounters (Sam's Club, Costco Wholesale, BJ's Wholesale Club, etc.), and builder channels (Home Depot, Lowe's, etc.). The retailers' large size enabled them to exert tremendous influence over home appliance makers in terms of prices, delivery, and credit terms.

Falcon and Its Subsidiaries in Mexico, Denmark, and Japan

Falcon, a publicly held U.S. company, is a global player in the home appliance industry with a wide range of products, including refrigerators, kitchen appliances, and laundry machines (washers and dryers). Falcon's 2004 sales were \$1.1 billion. Falcon's overall strategy was to participate in all three (low-price, mid-price, and high-price) segments of the appliance industry.

Among Falcon's subsidiaries are three foreign subsidiaries, one each in Mexico, Denmark, and Japan. The exact nature of each subsidiary's operations and their role in overall strategy is described below.

Falcon acquired a 100 percent interest in a Mexico-based producer of refrigerators in 1995. This subsidiary had the manufacturing capacity to cater to the growing Mexican demand for mid-priced refrigerators, its primary product. The refrigerators were designed, produced, marketed, and distributed in Mexico. In other words, the subsidiary incurred all its costs, and generated all its revenues, in Mexican pesos.

The Danish market had an attractive base of customers who could afford high-priced kitchen appliances and desired feature-filled cooking ranges. Demand

²This section draws from information about the global appliance industry from articles in the press, public information from annual reports, and a case on "Global Appliance Industry," INSEAD.

was not large enough, however, to justify putting up a scale-efficient manufacturing operation in Denmark. Moreover, the Falcon's U.S. plant that had a proprietary technology to produce high-quality fancy kitchen appliances had significant excess capacity. The Danish subsidiary was therefore set up in 1997 and the manager was given exclusive rights to market Falcon products in Denmark. The Danish subsidiary sourced the products entirely from Falcon's U.S. plant at a transfer price of standard full cost. There were no other suppliers with exact kitchen appliances in the market which gave the Danish subsidiary a distinct advantage. Most other companies in the kitchen appliances market in Denmark were small local companies, producing and selling their products in Denmark only.

The Japanese subsidiary was established in 1999 as a production unit. The Japanese engineers were excellent in component design as well as high-quality, low-cost manufacture. The subsidiary produced low-cost laundry machines (washers and dryers) and had exclusive rights to sell them in the U.S. to the discounters and builder channels under "store" brands that catered to the low end of the market. Manufacture of laundry machines in Japan was largely in the hands of several medium and large domestic manufacturers that produced energy-efficient and compact machines for sale in Japan. Other "private label" suppliers of laundry machines to discounters and builder channels in the U.S. consisted of local (U.S.) companies known for producing domestically using lean manufacturing techniques.

Budgeted and Actual Profitability of Falcon's Foreign Subsidiaries

In consultation with the subsidiary officers, and taking into account the expected changes in market conditions, Falcon's headquarters set budgets for subsidiaries at year-end. For the foreign subsidiaries, budgets were communicated in local currency (LC) as well as U.S. dollars, using the exchange rate at the end of the previous year. The 2004 budgets for the three subsidiaries are indicated below.

Subsidiary Budgets—2004			
	Mexico	Denmark	Japan
Budgeted no. of units*	200,000	50,000	250,000
US\$ Budgets:			
Sales	74,550,000	41,400,000	102,000,000
Costs	59,640,000	33,117,360	81,579,175
Profits	14,910,000	8,282,640	20,420,825
Local Currency (LC) Budgets:			
Sales	799,176,000	284,832,000	12,219,600,000
Costs	639,340,800	227,847,437	9,773,185,165
Profits	159,835,200	56,984,563	2,446,414,835

*Units represent refrigerators in Mexico, kitchen appliances in Denmark, and laundry machines in Japan.

Falcon's investment in the subsidiaries at the beginning of 2004 was as follows. The investments in the subsidiaries did not change materially during 2004.

	Mexico	Denmark	Japan
US\$ investment	149,100,000	20,706,600	510,520,625
LC investment	1,598,352,000	142,461,408	61,160,370,875

The actual number of units sold in each country, and the product mix, remained virtually the same (199,600 units, 50,700 units, and 249,000 units respectively in Mexico, Denmark, and Japan). The actual inflation in the home appliance industry in each country was almost identical to Falcon's expectations reflected in the budget above. The actual performance of the three subsidiaries for 2004 was as follows:

Subsidiary Performance—2004			
	Mexico	Denmark	Japan
US\$ Performance:			
Sales	74,563,850	42,109,552	11,515,435,972
Costs	59,626,129	32,417,764	9,521,015,957
Profits	14,937,721	9,691,788	1,994,420,015
Local Currency (LC) Performance:			
Sales	819,083,888	272,448,801	103,000,322
Costs	654,993,022	209,742,930	85,161,145
Profits	164,090,866	62,705,871	17,839,177

In tracking the budgets, Falcon used the average-of-the-year exchange rates, since sales and costs typically occurred uniformly over the year. The exchange rates were as follows:

Exchange Rates			
	Mexico	Denmark	Japan
Exchange Rate (LC per 1 US\$)			
2003 End	10.720	6.88	119.8
Average for 2004	10.985	6.47	111.8

The average economy-wide inflation in 2004 was 5.00 percent in Mexico, 4.30 percent in Denmark, 2.25 percent in Japan, and 2.30 percent in the U.S. The specific inflation in the home appliance industry in each country paralleled the economy-wide inflation in 2004.

Requirements

- Under the current performance-evaluation system (PES) at Falcon, how would you assess the financial performance of the division managers in Mexico, Denmark, and Japan? Which manager should be awarded the highest bonus, and which should be awarded the lowest bonus?
- Using the approach outlined in Appendix A, calculate the nominal and real changes in the exchange rates for Mexico, Denmark and Japan during 2004. In light of your calculations, what revisions, if any, would you make in the 2004 dollar budgets at the time of tracking them? How would you assess the

financial performance of the three country managers of Falcon? Which manager should be awarded the highest bonus, and which should be awarded the lowest bonus? Why? Evaluate the appropriateness of the three country managers' responses to the changes in the exchange rates.

3. If ROI, rather than profit margin, were used as the performance measure, would the performance ranking of the three subsidiaries be different? Describe the advantages and limitations of using ROI as the performance indicator. Would you consider ROI to be a superior metric of performance evaluation in comparison with Falcon's current metric?
4. Evaluate the appropriateness of Falcon's use of the beginning-of-the-year exchange rate for budget setting, and average-of-the-year rate for budget tracking. Describe the approaches for preparing country managers to better respond to inflation and exchange-rate changes.
5. Assume that for each of the past five years, the Japanese subsidiary has reported lower-than-budgeted profit margins and ROI in dollar terms. If adjustments are made for the real exchange-rate changes, however, its performance in each of those five years turns out to be better than the revised budget. Would you recommend closing the Japanese subsidiary? Why or why not?
6. Describe the strengths and weaknesses of the current PES for foreign subsidiaries at Falcon. What changes in the PES would you recommend?

Appendix A

Short Note on the Relationship between Exchange Rates and Inflation Rates

The purchasing-power parity (PPP) theory states that exchange rates between two countries will change by approximately the difference between their inflation rates. For example, if inflation is 4 percent in the U.S. and 0 percent in Japan, the dollar value of the Japanese yen would rise by about 4 percent. Stated formally, if i_h and i_f are the inflation rates for the home country and the foreign country respectively, then

$$e_t = (1 + i_h)^t$$

$$e_0 = (1 + i_f)^t$$

where e_0 is the dollar value of one unit of foreign currency at the beginning of the period, and e_t is the dollar value of one unit of foreign currency at the end of the period.

To illustrate, if the U.S. and Argentina have annual inflation rates of 4 percent and 14 percent respectively, and the spot rate today is one Argentine Peso (ARS) equals US\$0.33, then the value of the ARS in one year would be

$$e_1 = (0.33)(1.04/1.14)^1 = 0.301$$