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Cash pooling: An organizational response to institutional complexity

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ABSTRACT
The paper aims to explain how new cash management practices can be used to address institutional complexity in Multinational Enterprises (MNEs) and which are the effects on the organizational form. Based on a case study, cash pooling reveals to be an effective response for dealing with the financial crisis, even if shifting the complexity at an organizational level. Indeed, the MNE selected had to manage a centralized and decentralized organizational structure since the financial solution could not be adopted for all subsidiaries. The study shows that cash pooling can act as an organizational response only if a constant dialogue with subsidiaries is ensured.

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Introduction

Institutional complexity can lead to changes in both the organizational structure and practices (Greenwood, Raynard, Kodeih, Micelotta, & Lounsbury, 2011) and the organizational response to multiple and changing logics is unlikely to be uniform (Reay & Hinings, 2005; Washington, 2004). Previous studies have considered institutional logics in connection to different organizational practices, as business group strategies (Greve & Zhang, 2017), human resource management (Alvehus, 2018) and strategic entrepreneurship (Yiu, Hoskisson, Bruton, & Lu, 2014). However, there is no evidence about how new financial arrangements can act as an organizational response to institutional complexity. This paper, through a case study, aims to fill the gap by adopting an in-depth research protocol capturing the nested relationship between new micro-level financial practices and their impact on the organizational form. The research site, dubbed "GlassDesign", is a private medium-size global manufacturing company headquartered in Italy facing a unique set of institutional pressures due to the financial crisis. We selected this as a "particularly revelatory" case because it allowed exploring a significant phenomenon under rare

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circumstances (Eisenhardt & Graebner, 2007). The company changed its cash management policies by introducing cash pooling, which allowed the centralization of cash (CMS, 2010).

We find that the new cash approach was a suitable response even if shifting complexity at an organizational level by reducing the level of financial autonomy recognized to subsidiaries. The parent company had to manage both a centralized and decentralized form since the financial solution was adopted just for some subsidiaries. Moreover, simplifying cash management increased the liquidity risk managed by the headquarters making them responsible for all participating subsidiaries. The case study shows that for companies operating in an international scenario creating a win-to-win solution that satisfies all stakeholders is difficult to achieve (Pache & Santos, 2010). In fact, cultural and legal differences among subsidiaries in "GlassDesign" required tailored communication strategies to legitimize these financial changes. In the process, an open communication with subsidiaries held a key role in building legitimacy and in promoting a greater organizational integration. Therefore, the study contributes to the literature on institutional complexity and organization form by introducing financial management in the described framework. After presenting how institutional complexity can impact organizational behavior and how financial solutions can influence the organizational form, cash pooling is described. Second, the case study and findings are discussed, drawing managerial implications and conclusions.

Institutional complexity for understanding organizational behavior

Institutional complexity, as a result of multiple and changing logics, provides guidelines for understanding how organizations behave in their environment (Greenwood et al., 2011; Zilber, 2011). Institutional complexity is shaped by the organizational field that consists of "those organizations that, in the aggregate, constitute a recognized area of institutional life: key suppliers, resource and product consumers, regulatory agencies and other organizations that produce similar services or products" (DiMaggio & Powell, 1983, p. 148). As noted by Zilber (2011), knowledge about how organizations respond to conflicting and changing logics and their impact on the organizational form is limited. Previous studies have focused on scenarios where the organizational response is driven by the need to conform or the ability to resist (Dhalla & Oliver, 2013). Moreover, when dealing with institutional complexity, paradoxes are likely to emerge, as contradictory and interrelated elements that exist simultaneously and persist over time (Smith & Lewis, 2011). These contradictions emphasize the differential, oppositional nature of elements, while on the other they

capture synergies that persist over time (Schad, Lewis, Raisch, et al., 2016). These paradoxes due to different organizational responses can raise uncertainty and anxiety, resulting in defensive responses to reject and resist them (Lewis, 2000; Vince & Broussine, 1996). Such tensions are relevant for MNEs, which are involved in a multitude of social and legal contexts. Subsidiaries of the MNEs may differ in the scope of their operations, the extent of responsibilities they take, the importance of the markets they serve, their level of competence and their organizational characteristics (Manolopoulos, 2008). Therefore, for MNEs pursuing a win-to-win solution satisfying all stakeholders can be difficult to achieve, possibly jeopardizing organizational legitimacy (Pache & Santos, 2010). In this case, organizations may use formalized management tools to strengthen their external legitimacy (Modell, 2001) or engage in argumentation strategies with their stakeholders to maintain legitimacy (Palazzo & Scherer, 2006). The potential benefits of relaxation of parent control on subsidiaries can outweigh the costs, especially when addressing a context of environmental uncertainty (Kawai & Strange, 2014), such as institutional complexity. The appropriate balance between centralized parental control over MNEs foreign subsidiaries and their recognized autonomy has been one of the most challenging tasks for practitioners (Young & Tavares, 2004), leading to investigating the relationship of MNE subsidiary characteristics to subsidiary strategic and operational autonomy (Raziq, Borini, Perry, & Battisti, 2013).

Autonomy implies for subsidiary managers to have more managerial discretion in choosing how to leverage firm-specific resources, as technology, knowledge, human capital, and the financial ones. Studies on subsidiary autonomy pointed out that some firms allow their subsidiaries greater decision-making independence, while others assume tight control of subsidiary activities (Ambos, Asakawa, & Ambos, 2011) and that the strategy adopted can change over time (Dörrenbächer & Gammelgaard, 2006). In this decision, headquarters should also consider that decisions on overseas subsidiaries' actions and functions can hold implications in terms of multinational integration (O'Donnell, 2000).

Financial practices and their impact on the organizational form

The organizational response to multiple and conflicting logics (Reay & Hinings, 2005; Washington, 2004) is unlikely to be uniform. Institutional logics have studies in connection to different organizational practices, as business group strategies (Greve & Zhang, 2017), human resource management (Alvehus, 2018) and strategic entrepreneurship (Yiu et al., 2014). Instead, financial arrangements still need to be explored taking into account the recognized influence that financial solutions have on

organizational performance (Butt, Hunjra, & Rehman, 2010), especially when managing subsidiary autonomy (Hedlund, 1981).

In this sense, the study considers the nested relationships between micro-level financial practices and their impact on the organizational form. The concept of inward-focused organizational response is considered as a response that organizations can pursue during institutional complexity by introducing new financial arrangements, as cash pooling.

Cash pooling is a financial management technique allowing centralization of cash within an organization by combining cash balances of units, including subsidiaries. Each entity participating in cash pooling transfers their cash balance physically or virtually to the "master account", typically held by the parent company (CMS, 2010). As the interest is calculated on the total balance, the company can decrease overall debt to financial institutions and reduce costs. To decrease liquidity risk, units would not need to borrow externally but can be funded through the cash pool at a more competitive rate (Jansen et al., 2011). There are different types of cash pools and distinction is made between physical and notional (virtual) cash pooling. In the case of notional cash pooling, the balances of the participating entities do not transfer but the interest rate is calculated based on the netted balance of all participating accounts (Jansen et al., 2011). The group can benefit from interest optimization, but each participating subsidiary still has their bank account with the full physical balance. The banking partner calculates the interests based on the net value of all the accounts linked, without cash being moved to one account. With physical cash pooling, physical transfers of cash are made from all participating accounts to a master account of the parent company, thus, centralizing the cash flows leads to the centralization of the banking relationship. In fact, an efficient cash pooling system, as the case study confirms, relies on one or two banking partners. Few data are obtainable in the European Union to quantify cash pooling activities in their various forms. However, according to qualitative information, the phenomenon is relevant especially among Western and Northern European countries. Indeed, the banking systems in the United Kingdom, France, and the Netherlands have been highly active in providing these services (Colangelo, 2016). Further, from a legal point of view it should be considered that the financial transactions under a cash pool agreement are not carried out in favor of the public but only within a corporate group, thus a banking license for intra-group loans is not needed. Nevertheless, in Austria, Germany and Ireland, creditor protection is ensured by requiring additional monitoring duties with respect to the financial situation of the companies that are participating in a cash pool. In the case of detrimental transformation of the groups' financial position, a company might have the possibility to conclude its cash pooling participation (see Jensen, 2001).

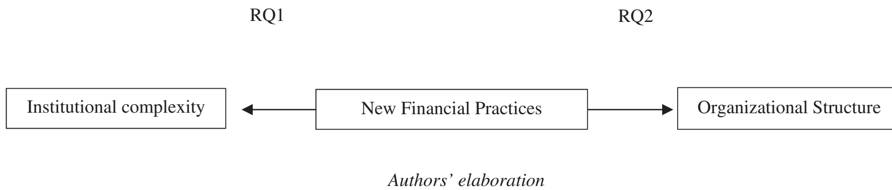


Figure 1. Research protocol.

Methodology

The research protocol

Our research design relies on a case study for several reasons. Case studies are appropriate when (1) the research questions are about "how" and "what", (2) researches do not have much control over events, and (3) investigating a contemporary phenomenon in its real-life context (Yin, 2003). Case studies have proved useful in previous studies investigating the impact of institutional logics since case studies allow reaching multi-level insights into the relationship of practices and institutional logics (Smets & Jarzabkowski, 2013). Since intra-organizational processes influence the organizational responses to institutional complexity, a deep understanding of these processes might help to explain the variety of organizational responses (Greenwood et al., 2011). The intention is to understand how new financial arrangements can act as a response to institutional complexity. We focus on the inward-focused responses, which include strategic decisions of centralized or decentralized control of assets and resources by considering the levels of autonomy recognized to subsidiaries (Bartlett & Ghoshal, 1987).

Through the case study we provide an answer to two leading research questions by including new financial arrangements in the framework of institutional complexity and organizational form, as presented in Figure 1.:

R.Q.1 "How can new financial practices address institutional complexity?"

R.Q.2 "How can new financial practices impact the organizational form?

We followed the introduction of the new cash management approach in the company from 2009 till 2018. We rely on multiple data sources, combining interviews and archival materials, to capture the organizational response in the environment of institutional complexity. The semi-structured interviews were addressed to the CEO and the financial manager of the parent company, which held a key role in the introduction of the new financial solution.

"GlassDesign" as a revelatory case

Our research site, dubbed "GlassDesign", is a private medium-size global manufacturing company headquartered in Italy. It was established in 1958

Table 1. List of GlassDesign subsidiaries and applicable currency.

Location	Currency
China	Renminbi
Finland & Baltic	Euro
France	Euro
Germany	Euro
Benelux	Euro
Hong Kong	Hong Kong dollar
Italy	Euro
North America	Canadian dollar
Norway	Norwegian krone
Russia	Rubble
Singapore	Singapore dollar
Spain	Euro
Switzerland	Swiss franc
UK	UK pound

and started to enter the international scenario with subsidiaries across Europe, North America, and Asia (Table 1).

In 2008 GlassDesign started to face pressures due to the financial crisis. Before the crisis, the prevailing institutional logic was to rely on banks to provide liquidly. Most of the macroeconomic literature overlooked banks as a source of friction due to perceived broader distribution of the credit risk across the financial system (Gambacorta & Marques-Ibanez, 2011, p. 138). However, the lack of funding available contributed to banks' reduced ability to extend credit (Di Patti & Sette, 2012) and to the deterioration in business conditions. While the Italian economy was contracting by the end of 2008, the increase in loan defaults and the decrease in funding availability added to the transmission of the financial shock to the firms. Institutional complexity, shaped by the modified role of the banks for credit access, especially for small medium-sized enterprises (Paulet, Parnaudeau, & Abdessemed, 2014), created challenging conditions for businesses giving rise to institutional complexity. Organizations were struggling to meet their cash needs forcing them to reevaluate the role of the banks and the risk exposure in the global financial markets. The need for financing led some firms to use the corporate bond market even if facing a very high interest rate (Gambacorta & Marques-Ibanez, 2011). These institutional conditions forced "GlassDesign" to pursue other options.

Findings

Cash pooling as the organizational response to institutional complexity

The need for financing and the inability to obtain it from external sources pushed "GlassDesign", which was experiencing a 24% drop in revenues in 2009, to pursue more entrepreneurial approaches. The existing loan

commitments and changes in the product specification further added to the liquidity pressures. These challenging conditions became the jolt to examine more efficient ways to manage internal resources. Previously, changes to cash management practices were not considered necessary. Due to the financial crisis, the treasury teams faced increasing pressure to effectively manage liquidity and funding, but banks could not always meet these organizational needs or charged high interest rates. As highlighted by Greenwood, Diaz, Li, and Lorente (2010), the lack of focused external demands amplifies institutional complexity to which organizations respond to. In the case, the financial crisis motivated GlassDesign to contemplate alternative and more flexible financial arrangements due to the urgency of the situation. The option of cash pooling was recommended by the top management of GlassDesign to centralize cash management at the headquarters. GlassDesign approached subsidiaries in the following countries to participate in cash pooling: France, Germany, Benelux[1], Spain, Switzerland, and the United Kingdom. The headquarters selected one bank that has a presence in these countries for each subsidiary to have a linked account. The motivation to adopt cash pooling, as underlined by the financial manager was: “*not only driven by the possibility to aggregate cash and save costs but also to gain broader control over cash for headquarters*”

In fact, before the financial crisis, each of the subsidiaries managed their operations and cash. Under the decentralized cash management, each subsidiary was charged and earned bank interest based on their financial position and had to budget and manage their liquidity risks. Each year subsidiaries transferred cash to headquarters based on the yearly net profit. The transfers occurred once a year, required board resolution, and incurred additional taxes. Across the group, there were approximately 80 bank accounts with 43 banks, which were expensive to maintain and monitor. These external and organizational factors driven by the changing institutional logics allowed exploring cash pooling to better manage internal cash resources. GlassDesign was seeking, through cash pooling, to gain greater control over financial flows to reduce liquidity risks. Given the instability in the financial sector, the company wanted to decrease its reliance on financial markets. Cash pooling would permit closing some local bank accounts to reduce costs and internal complexity. Therefore, with centralized cash management, the company expected to cut costs, improve margins, and transfer cash management responsibilities to headquarters. As stated by the CEO and financial manager, the internally focused response was chosen out of necessity to “*take back control*” and decrease dependency on the financial markets. Further, it should be considered that the spread applied from cash pooling results lower respect to that of local banks. The benefits achieved by the new cash management practice as specified by the

financial manager resulted in: "*cash pooling improved banking relationships, leading to cost advantages and greater investment opportunities. The financial solution allowed lowering managerial complexity through automatic reporting, aligning the banking and the internal system of the company. Lastly, the new cash management led to consider the opportunity of including new subsidiaries and funding new ventures internally without being dependent on expensive external capital*".

On the other hand, at subsidiary level "*after the initial concerns in losing their financial autonomy, subsidiaries became aware of the benefits that could be achieved through cash pooling*". In fact, cash pooling allowed covering the financial needs of subsidiaries on a daily basis without too much bureaucracy involved. Contrary, before the introduction of cash pooling, an increase in capital would have been necessary. This latter solution would have resulted in a long and costly procedure. Instead, cash pooling ensures less bureaucracy, direct financial costs, banking operations and current accounts to manage. Therefore, subsidiaries can take advantage from a higher level of security and financial stability, ensured in an immediate and concrete way. As a consequence, cash pooling has also broad implications on how GlassDesign operates within financial markets and expands internationally.

Shifting complexity at the organizational level

Even if the new cash management removes institutional complexity through the centralization of liquidity and simplification of the banking structure, different complexities arise in the organizational form. Being a process crossing borders, there are legal considerations, as differences in how the banking law of each participating country treats cash pooling. As a matter of fact, corporate law varies in terms of the set-up process and related disclosures and cash pooling requires agreements to be formalized between the participants, parent company and bank.

For this matter, GlassDesign obtained legal opinions for each participating country to ensure that the cash pooling structure would not violate any legal requirements.

GlassDesign chose to implement zero-balancing cash pooling where cash balance for each participating subsidiary is zeroed out daily. The positive and negative balances are rolled into the parent account and an established intercompany rate of interest is applied. This new cash management allows optimization of the interest rate and provides headquarters with additional control over cash as all balances are transferred to the account of the parent. Participating subsidiaries experienced a loss of control in managing their cash balances. Previously, each subsidiary was responsible for

maintaining enough liquidity while with cash pooling, their focus shifted to managing daily operations. The parent company forecasts their cash needs and manages liquidity risk for the group. Therefore, the solution provided headquarters with greater oversight over transactions of the participating subsidiaries.

Although there was a cash crunch experienced by the parent, cash pooling required a paradigm shift at the local subsidiary level. From the tax perspective, the company had to manage transfer pricing by getting familiar with setting an arm's length interest rate to ensure compliance with tax regulations. As mentioned, in order to make cash pooling work, subsidiaries needed to support the new arrangement. One of the main challenges recognized by the parent company was the difficulty for subsidiaries to give up their control over the cash balance. One of the major concerns was that units with positive balances could see their individual returns decrease for the benefit of the group since positive and negative balances are netted to the parent.

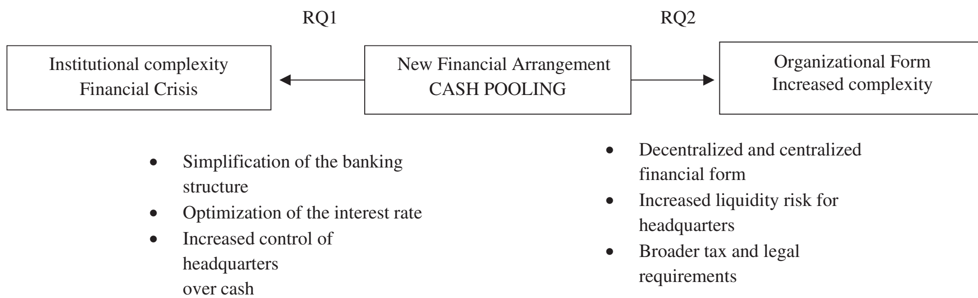
Organizational complexities linked to cash pooling emerged due to the increased liquidity risk managed by the headquarters who had to be responsible for all subsidiaries participating in the cash pool in addition to broader legal and tax requirements of locations around the world. The headquarters had to consider the legal requirement of the countries in which the subsidiaries were based. Among European countries the process was facilitated by common regulations in force, whereas for Switzerland and other extra-European countries the process resulted to be longer. For Switzerland, there is no specific statutory framework dealing with cash pooling. Until 2014 it was generally agreed that rules and limitations contained in the statutory provisions and related case law on capital maintenance and profit distribution apply in specific circumstances to the contribution of funds to a cash pool. In a landmark decision of 2014, the Swiss Federal Court presented severe guidelines that should be considered by companies participating in a physical cash pool (CMS, 2017).

Moreover, the centralization of cash occurred for some but not all subsidiaries. For participating subsidiaries, cash activities were centralized with headquarters while other functions remained under their control. The decision not to include all subsidiaries was related to the absence of significant operations or cash balances to justify the investment and the complications related to the daily transfers of different currencies. Other subsidiaries, as those in China and Russia, have regulations that do not allow transfers that are required under cash pooling. In Russia, cash pooling is still a new concept. There is no unified legislation that regulates cash pooling agreements and the legal framework in which cash pooling operates comprises general civil and insolvency law provisions, as well as

banking and tax law regulations (CMS, 2017). On the other hand, in China, a step-by-step approach has been recently adopted to liberalize foreign exchange control, but the cross-border inflow and outflow of funds, especially those under capital account items, are strongly regulated. Moreover, cross-border cash pooling arrangements are subject to the administration and supervision of the State Administration of Foreign Exchange and its local counterparts (CMS, 2017). Hence, due to these differences, "GlassDesign" was called to leverage a new organizational form combining a decentralized approach and a more centralized structure managing different levels of subsidiaries' financial autonomy.

Building legitimacy in an international context

The global nature of the enterprise poses communication challenges related to geographic distance, different time zones, and especially diverse national cultures (Fulk & DeSanctis, 1995). For GlassDesign, the combination of centralized with decentralization form helped to alleviate institutional complexity related to cash and banking management but led to further challenges in building organizational legitimacy. Consistent with the Italian and local laws, subsidiaries participating in cash pooling had to consent to participate and move their cash to Italy. In this process, the treasury department covered a key function in building legitimacy for the project between headquarters and local companies. The department had to manage liquidity risks by drawing on the group's cash balances, focusing on interest optimization, budgeting and oversight. The changes required a more formalized treasury department that not only become responsible for overall liquidity but also coordinated cross-border legal and tax issues. In such a process, the treasury team worked closely with legal representatives, accounting, and IT departments as their processes were impacted by cash pooling. In addition to communication with local partners, the support of the top management for cash pooling resulted instrumental in progressing it forward. Nevertheless, some relevant differences emerged among subsidiaries. Subsidiaries in Spain, Benelux, and the UK, when presented with the need for a cash centralized management, quickly agreed to proceed. These subsidiaries were more comfortable with a more centralized cash management approach and proceeded with the transition once the CEO of the group reiterated the need for change. Instead, subsidiaries in France, Germany, and Switzerland required additional effort. These subsidiaries had different apprehensions about the proposed change. For example, one subsidiary had concerns about moving cash to the parent and on the legal implications of the transfer. Another one was not eager to participate but, once the structure and details of the cash pooling were communicated clearly, they decided to proceed. Indeed, a constant communication



Authors' elaboration

Figure 2. Cash pooling: an organizational response to institutional complexity.

with the subsidiaries resulted crucial in building organizational legitimization. From the start, different meetings with the top management of the foreign subsidiaries were organized to make them aware of the benefits of cash pooling focusing on the importance of a common vision based on shared objectives. Not only foreign subsidiaries needed to become aware of the new financial arrangement but also Italian collaborators needed to understand the impact of such change having to deal with new legal and tax issues. Therefore, different training activities were organized to introduce them to the new logics focusing also on the implications for the organizational form.

Discussion

The case presented allowed to explore how financial solutions can represent an organizational response to institutional complexity, even if shifting this complexity on the organizational form. As presented in Figure 2, Cash Pooling allowed to address the financial crisis, capturing costing and managerial advantages (RQ.1). However, the introduction of the new financial arrangements changed the organizational form of the MNE since it was not possible to adopt cash pooling for all the subsidiaries. This solution led to recognize different levels of financial autonomy to subsidiaries, increasing the liquidity risk of headquarters, who were called to deal with greater tax and legal requirements (RQ.2)

Concluding remarks

Although based on a single case, the evidence from GlassDesign provides insights into how financial approaches can be used for addressing institutional complexity, as the financial crisis, in the context of MNEs. Cash pooling not only affected the management of the existing resources but contributed to relevant changes in the organizational form. However,

without a constant dialogue between different units, cash pooling can exuberate cultural differences that exist, leading to greater organizational complexity. We found evidence on the role that a constant dialogue with subsidiaries held in creating organizational legitimacy across international borders, which in turn maximized the benefits for multinational integration (O'Donnell, 2000). Cash pooling as confirmed in GlassDesign can promote more frequent communication between headquarters and subsidiaries, in line with the findings of Palazzo & Scherer, 2006 according to whom MNEs can engage in argumentation strategies with their stakeholders to maintain legitimacy. The perception reported by the interviews was that cash pooling helped to build organizational integration, focusing on the performance of the group instead of that of individual subsidiaries. If successful, as in the case examined, the new financial arrangement in conjunction with information technology can create a stronger link between units and "institutionalized dialogue" (Heckscher, 1994). Based on the limits of the current research, we provide some new directions. Firstly, it would be insightful to investigate other cases of firms facing institutional complexity analyzing the implication of different financial solutions on the organizational form. Then, it would be of interest to understand if and how these changes allowed to maximize the potential benefits for multinational integration (O'Donnell, 2000). Moreover, the case presented is explored only from the perspective of the parent company, thus future research should include also findings from subsidiaries involved in the process, understanding the changes incurred in their organizational structure.

Note

1. Benelux is a union of states consisting of three neighboring countries in midwestern Europe: Belgium, the Netherlands and Luxembourg.

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