

Controlling Newly Established Foreign Subsidiaries in Transition Economies

Abstract

This paper investigates the management control system choices exercised by a multinational corporation headquarters to control a newly established wholly owned foreign subsidiary located in a transition economy. Specifically this paper aims to identify what the core challenges of establishing and operating subsidiaries in transition economies are and how these are addressed through the multinational headquarters' management control systems. A case study is conducted of an Eastern European based subsidiary owned and controlled by a multinational corporation originating from South-East Asia. The challenges of operating the subsidiary in the transition economy are reported, which primarily entail cultural differences, lack of experience, lack of external integration and recruitment issues. Preliminary findings indicate that the management control system primarily utilises personnel and results controls, which appear to address operational and management challenges.

Key words: Wholly Owned Subsidiaries (WOS); Management Control Systems (MCS); Foreign Operations; Establishment; Transition Economies; Control

1. Introduction

Control of wholly owned foreign subsidiaries in transition economies is regarded as a challenging and often perplexing issue for multinational corporation headquarters, particularly those located at a significant distance from these entities (Ghemawat 2001). This issue is further complicated during the establishment of wholly owned foreign subsidiaries (Davila 2000). The objective of this study is to identify core challenges and the effect of these on management control system choices exercised by multinational headquarters. Specifically these challenges concern those associated with the transitional economic environment. Coping with core challenges appears critical given wholly owned foreign subsidiaries (WOS) are a key mechanism of international expansion for multinational corporations (MNC) (Jausaud & Schaaper 2006), allowing them to take advantage of economies of scale and scope in increasingly integrated global markets. The opportunity to use WOS as a means of market entry has increased vastly, resulting from the removal of

government imposed barriers and emergence of open market transition economies (Guse, Bremmers & Omta 2005; Southworth 1994; Yan & Gray 1994). While there appears to be vast opportunities to use these entities as a means of expansion, the challenges of operating the entities including environmental uncertainty, cultural differences and increased global competitiveness may hinder the success of these entities (Agbejule 2005; Efferin & Hopper 2007; Mason 2007). Therefore appropriate management control systems selection appears critical to cope with such challenges and ultimately operate successful WOS.

There appears to be an increasing preference towards the use of WOS as a means of international expansion into both developing and transition economies (Beamish & Jiang 2002). While the removal of government imposed barriers to market entry allows this method of expansion to be utilised in many developing and transition economies over the last two decades (Guse, Bremmers & Omta 2005; Southworth 1994; Yan & Gray 1994), it appears that greater experience and confidence is central to the preference towards WOS use. According to Li, Quin, Lam & Wang (2000) multinational corporations appear to opt towards WOS as they gain greater experience in foreign markets, rather than other forms of market entry including international joint ventures (IJV).

Research focusing solely on the WOS organisational form is limited. Extant literature frequently fails to differentiate between IJVs and WOS for the purpose of investigation and analysis (Jaussaud & Schaaper 2006). This appears to be a fundamental flaw given the absence of unique collaborative dynamics associated with joint ventures (Giacobbe 2007) in WOS. Accordingly the management control system choices exercised over IJVs and WOS may differ considerably (Gomes-Casseres 1989; Jaussaud & Schaaper 2006; Talay & Cavusgil 2008). This study is motivated to investigate the effect of transition economy related challenges on management control system choices in the WOS context.

This paper addresses the research question; what are the core challenges associated with transition economies that affect the choice of management control systems exercised by multinational headquarters over their WOS? To answer this question an exploratory case study is undertaken of a recently established wholly owned foreign subsidiary located in an Eastern European country, owned by a large international electronics component manufacturer. This paper contributes theoretically by inductively identifying and investigating how core challenges affect a comprehensive management control systems framework. Using a comprehensive MCS framework, avoids one the limitations of literature, concerning the often narrow focus on one particular MCS dimension (Chenhall 2003; Merchant & Van der Stede 2003; Simons 1994). This paper contributes to practice by

providing decision making guidance to multinational headquarters in the selection of controls to cope with core challenges when operating in a transition economies, particularly during subsidiary establishment.

This paper is organised as follows. The literature review, highlighting limitations, suggestions and gaps in literature, that may be addressed is presented in section 2. The research design, specifically entailing the exploratory case study method is detailed in section 3. The results and analysis of results are presented in section 4. Finally the conclusion and directions for future research are detailed in section 5.

2. Literature Review

Wholly Owned Foreign Subsidiaries

A wholly owned foreign subsidiary refers to a fully owned entity located overseas from the multinational corporation owner. These entities are regarded as an important means of international expansion for MNC to capitalise on the potential of foreign economies (Chan, Makino & Isobe 2006). Literature suggests that the greater the market potential as measured by market size, the higher the likelihood that multinational headquarters choose to enter a foreign market using foreign direct investment such as a WOS (Kwon & Konopa 1993; Terpstra & Yu 1988) due to the higher returns that can be realised on such investment (Quer, Claver & Andreu 2007). Foreign market potential may be further strengthened through the presence of a MNC current customers or clients in a previously untapped market. According to Martin, Swaminathan & Mitchell (1998) the expansion of a client firm into a foreign market encourages supplier firms to enter this market due to prior relations established between these entities. In addition the presence of competitor firms in a foreign market leads to greater information availability concerning market potential and cost saving, also encouraging MNC to set up foreign based WOS (Holm & Sharma 2006; Martin, Swaminathan & Mitchell 1998). Therefore it appears that the use of WOS is a key means of realising and capitalising on foreign market potential and opportunities.

Access to location specific resource endowments in foreign markets appears to be a key reason MNC utilise WOS as a means of international expansion. It appears that the sustained competitive advantage of a firm is found in the strategic resources endowments it possess, in terms of both organisational knowledge and capabilities, for example the access to lower cost production, knowledge and particular input resources (Tallman & Fladmoe-Lindquist 2002). The ability of multinational corporations to combine unique resources

through international operations is argued to be necessary for sustained competitive advantage, allowing a firm achieve superior performance (Forsgren, Pedersen & Foss 1999; Prahalad & Hamel 1990). Therefore the use of WOS appears to be critical to access and take advantage of specific resource endowments of foreign markets for the greater benefit of multinational corporation entities.

The lack of collaborative arrangements when multinational headquarters engage in WOS suggests that multinational headquarters may have significant issues choosing appropriate MCS, even though they don't deal with collaborative dynamic challenges (Anderson 1990). These issues stem from possible challenges associated with controlling a WOS from a distance, resulting from factors including culture, external environment uncertainty and strategic coordination issues (Abdel-Kader & Luther 2008; Ghoshal & Nohria 1989; Haldma & Lääts 2002). These issues appear to be complicated where a multinational headquarters has limited prior experience, particularly during the establishment phase (Muralidharan & Hamilton 1999) and cannot rely on the assistance of another parent partner or entity.

Transition Economies

A transition economy is characterised by the movement from a centrally planned to market economy. Specifically this movement involves a process of industry privatisation, liberalisation and macroeconomic stabilisation (Gabrisch & Holscher 2006). As part of this process, governments of transition economies including Czech Republic, Hungary, Poland and Slovenia have encouraged foreign direct investment in an effort to inject much needed capital, employment, knowledge and expertise into these economies (Mandel & Tomsik 2008).

There has been significant foreign direct investment in transition economies, accounting for 30% of the worldwide foreign capital flow (UNCTAD 2005). There are three core reasons for such capital flows; market seeking, efficiency seeking and resource seeking (Dunning 2001). While market seeking is often a key factor for MNC entrance into transition economies, there is a considerable rise in the importance of efficiency seeking which is focused on increasing a multinationals overall competitiveness. The relative cost benefits of operating and producing in transition economies, coupled with the presence of skills labour and local supplies is argued to be of importance to the decision of MNCs to invest in these

economies (Mandel & Tomsik 2008). Despite the efficiency motives and benefits associated with foreign investment in these economies, the challenges of operating in these economies may be greater, including coping with environmental uncertainty, cultural differences and integration issues resulting from the lack of knowledge, experience and the dynamic nature of change in these economies.

Management Control Systems

The term control refers to the processes through which one entity influences the behaviour, operations and output of another entity (Ouchi 1977). A management control system refers to a set of systems or mechanisms used by management to control a particular entity (Chenhall 2003). This paper considers the MCS exercised by a multinational headquarters to control a foreign WOS from a distance. The choice of these MCS appears critical given the challenges of controlling from a distance, inability to leverage off the expertise of a local parent partner and (sometimes) lack of relevant experience by multinational headquarters.

There is a diversity of means in which MCS is considered in extant literature. There is a number of control frameworks conceptualised in literature, providing a more comprehensive view of the management control systems packages (Merchant & Van der Stede 2003; Simons 1994). However many studies in management accounting literature only consider one or a limited number of dimensions in these control frameworks. While this limitation is particularly emphasised in earlier studies given the evolution of MCS research towards incorporating informal control mechanisms, it still remains a prominent issue in more recent studies (Jaussaud & Schaaper 2006). This is particularly the case regarding the significant focus on performance measurement systems or results controls and limited consideration of other control dimensions (Busco, Giovannoni & Scapens 2008; Dossi & Patelli 2008). This narrow focus is inadequate. According to Busco, Giovannoni and Scapens (2008), while performance measurement systems are necessary to manage the tensions in global multinational organisations, they are incomplete since informal mechanisms are needed to challenge and reinforce such formal control mechanisms.

Merchant and Van der Stede's (2003) conceptualise control dimensions in a cohesive set, rather than isolation elements (Widener 2007), therefore providing a comprehensive control set of formal and informal mechanisms, and also an integrated set. The control framework consists of four dimensions; results, action, personnel and cultural controls. We

use this comprehensive control framework as it allows researchers to consider how multinational headquarters exercise a range of control choices to cope with core challenges.

We now briefly review Merchant and Van der Stede's (2003) dimensions of control.

Results controls

Involve analysing the performance of employees according to targets and rewarding them accordingly. There are four elements to results controls; defining the dimensions on which results are desired, measuring the performance on these dimensions, setting targets for employees to achieve and providing rewards to encourage employee behaviours that lead to the achievement of desired targets.

Action controls

Involve ensuring that employees perform (or do not perform) certain actions that are in the best interest of the organisation (or not in the best interest). There are four key forms of action control; behavioural constraints stopping employees taking undesirable actions, preaction reviews that involve approving or disapproving of proposed actions, action accountability which involves holding employees responsible for action they take and finally redundancy where more employees are assigned to a task than necessary.

Personnel controls

Build on employee's natural tendencies to control and motivate themselves through clarifying organisational expectations, ensuring employees are able to do a good job and increase their likelihood of engaging in self monitoring. Implementing personnel controls involves selecting the right employees, adequate training, ensuring appropriate job design and allocation of sufficient resources to employees.

Cultural controls

Encourage mutual monitoring which is a powerful form of group pressure on individuals deviating from group norms and values. Methods of implementing and shaping cultural controls include establishing codes of conduct, group based rewards, intra-organisational employee transfers and corporate management tone.

Factors Affecting Management Control System Choices

There is a substantial body of literature investigating the effect of contextual based factors on management control system choices. Prominent factors investigated in literature include strategy, culture and external environmental uncertainty (Chenhall 2003). However there appears to be limited consideration of the core challenges that influence the control of WOS operating in transition economies, particularly during the establishment phase of these subsidiaries. Given WOS are generally established for the long term, compared with other forms of international expansion such as IJVs (Southworth 1994; Steensma et al. 2005), it is critical to understand an optimal fit between core challenges and MCS choices from the start.

The establishment and early development stage of a subsidiary significantly complicates the issue of coping with the challenges of operating in a foreign environment due to issues concerning the little administrative information available concerning the foreign subsidiary (Muralidharan & Hamilton 1999). It is not until the intermediary development stage that the subsidiary often gains market share, establishes production facilities and develops a presence in the local market, that it is in a better position to cope with a foreign environment (Hamel & Prahalad 1985; Sugiura 1990). To further complicate the ability to establish foreign operations, there are a number of challenges that may be present in the transition economic setting. How multinational headquarters respond to these challenges through management control system choices may determine the success or otherwise of a WOS. The following sections review literature concerning prominent challenges and the relationships with MCS choices identified in literature, which may be applicable to the transition economy context. The findings and suggestions of literature are used for the basis of further investigation conducted in this study.

Environmental Uncertainty

The level of environmental uncertainty stemming from changes in customer preferences, market demand, customer and supplier relations, number of competitors, increasing deregulation and globalisation appear to be key challenges when operating WOS (Hoque 2005). The difficulties associated with coping with environmental uncertainty have intensified in recent times as changes occur faster than ever before (Mason 2007). There are four key factors used to define the external environment in extant literature; turbulence (unpredictability and ambiguity), hostility, diversity (product, supplier and customer variety) and complexity (level of technological change) (Chenhall 2003). While these multiple

factors may be useful in the defining the environment, there is a dominant focus on uncertainty arising from the dynamic and uncertain nature of the external environment, suggesting that this characteristic is most challenging and problematic when engaging in foreign operations (Chapman 1997; Fisher 1998; Hartmann 2000). This is particularly the case in transition economies as considerable economic and institutional change occurs, increasing environment uncertainty.

Extant literature suggests that higher levels of environmental uncertainty are associated with more subjective performance evaluation and greater use of informal control mechanisms (Bloom & Milkovich 1998; Martinez & Jarillo 1989). These control choices are consistent with higher levels of autonomy extended to managers of business entities as uncertainty increases (Ezzamel 1990). The use of strategic and sophisticated management accounting systems also appears to be associated with higher levels of environmental uncertainty (Abdel-Kader & Luther 2008; Agbejule 2005) in national based companies. Despite the suggestions of literature there appears to be significant scope for further investigation, particularly in the establishment phase of a subsidiaries controlled at a distance, which receives limited attention.

Lack of Experience

Literature suggests that multinational headquarters with greater experience are more competently able to choose an optimal mix of management control systems, particularly in developing economies where market and operating characteristics differ significantly from developed economies (Moilanen 2007). By converse, lack of experience may be regarded a significant challenge when controlling WOS. This may be the case in transition economies where headquarters have limited experience in coping with the dynamic and evolving nature of the business environment as the transition is made to a market economy. The challenge concerning lack of experience is consistent with organisational learning theory, which suggests relevant learning improves decision making, particularly regarding assimilating to new external information and using it for commercial means (Cohen & Levinthal 1990). The value of experience is demonstrated by multinational corporations' frequent engagement in collaborative entities such as international joint ventures as a parent partner seeks to gain experience and knowledge of developing and transition economy market characteristics, with the eventual aim of starting a wholly owned foreign subsidiary (Southworth 1994; Yan & Gray 1994). Literature suggests that prior experience including involvement in IJVs leads to

superior foreign based WOS performance (Luo 1999; Miller & Eden 2006; Ogasavara & Hoshino 2007; Tsang 1999). Therefore a comparative lack of experience appears to be significant challenge.

There is very little research reported in literature regarding the effect of experience on MCS choices. The significant differences associated with developing and transition economies including market characteristics, pace of change and reform (Chow, Shields & Wu 1996; Mandel & Tomsik 2008; Moilanen 2007; Southworth 1994) mean that the choice of MCS maybe critical to cope with the challenge of a lack of experience. Therefore it appears important to investigate whether experience has an effect on MCS choices.

Cultural Differences

The dimension of culture can be defined as patterned and interrelated traditions, transmitted over time (Kaplan 1965). Specifically Hofstede (1984) defines culture as the collective programming of the mind which distinguishes the members of one category of people from those of another. The majority of research concerning national culture uses the typology conceptualised by Hofstede (1984) consisting of power distance, individualism, masculinity, uncertainty avoidance and the later addition of confucius dynamism (Hofstede & Bond 1988). There are many studies in literature suggesting significant differences in national culture in different countries and regions (Hofstede 1984). Despite the suggestions of extant literature, there have been significant criticisms levelled at the study of culture and the relationship with MCS choices. These criticisms include failure to consider all cultural dimensions, the differences in relative effects of cultural dimensions and simplistic conceptualisation of culture (Efferin & Hopper 2007; Harrison & McKinnon 1999).

It is largely acknowledged in the extant literature that national culture appears to be a challenge when operating abroad. However no definitive findings have been put forward concerning what or if culture significantly affects MCS choices, particularly in the case of multinational headquarters controlling WOS operations from a distance. According to Chenhall (2003) there is mixed results and limited consensus in the literature as to whether culture affects MCS choices. Accordingly there is significant scope to investigate whether national culture is a key challenge affecting MCS choices. This is particularly important in the context of transition economies where often, there is not a clear understanding of cultural characteristics and the similarities or differences compared with developed economies in which multinational headquarters are based. Investigating the effect of culture through a case

study method should provide a rich source of data to understand relevant relationships, beyond the simplistic conceptualisations used in prior literature.

External Integration

The level of external integration is defined as the total sum of interdependencies resulting from a subsidiary's position in an external business network (Andersson & Forsgren 1996). The external business network refers to the relationship with actors outside the MNC entity, including customers, suppliers and competitors. Subsidiaries with lower levels of integration into the external business environment are not able to gather and absorb knowledge from its environment to the extent of more highly integrated subsidiaries (Hansen 1999; Lane & Lubatkin 1998). Lack of integration in a transition economy that is dynamically evolving and changing may be particularly challenging. External integration in such a context would allow greater access to information concerning economic trends and dynamics, putting the subsidiary and headquarter in an improved position to cope with these factors. Accordingly, lower levels of external integration, particularly when a subsidiary is being established in a transition economy is a challenge that a multinational headquarters may need to address.

Given lower levels of external integration may be a key challenge when establishing foreign operating from a distance, it may have significant effects on MCS choices exercised by multinational headquarters. Andersson & Forsgren (1996) found that higher levels of external integration lead to lower degrees of perceived control exercised over the subsidiary by the multinational headquarters in the context of subsidiaries owned by Swedish MNCs. The measurement of perceived control in Andersson & Forsgren's (1996) study according to the possibly of the subsidiary introducing a new product without consulting the headquarters means there is significant scope for further investigation on the relationship between external integration and a broader set of control dimensions choices. In addition, while Andersson, Bjorkman & Forsgren (2005) investigate the effect of control choices on integration, there appears to be no further research on the effect of external integration on MCS choices. Therefore there is significant scope to understand whether certain levels of external integration are a key challenge that may affect MCS choices.

Summary of Literature

The use of WOS appears to be an important means of international expansion for multinational corporations, particularly in transition economies. Despite this there appears to be a number of challenges that multinational headquarters face when controlling these entities from a distance including environmental uncertainty, limited experience, cultural difference and low external integration. Dealing with these challenges may be complicated further during the establishment of foreign operations in transition economies. There is a range of management control system dimensions presented in literature, notably Merchant and Van der Stede's (2003) control framework, consisting of results, action, and personnel and cultural control dimensions. Much of management accounting literature considers MCS in a narrow sense, in many cases only considering results based control mechanisms. Accordingly there is little known regarding the effect of challenges on a comprehensive set of management control systems. In particular there is limited knowledge on what are the core challenges and the effect of these on MCS choices in the transition economic setting during subsidiary establishment.

3. Research Design

There is limited literature concerning the effect of transition economy related challenges on headquarters MCS choices over wholly owned foreign subsidiaries. Accordingly a single case study approach is taken to investigate the research question proposed, in order to gather a deeper understanding of the relationship between challenges and MCS choices, through richer data associated with this method (Ahrens & Dent 1998; Dyer & Wilkins 1991). As put forward by Yin (1988), this exploratory research method is necessary to build initial knowledge, leading to a set of testable theoretical propositions (Eisenhardt 1989). Given the limited literature concerning the relationships investigated in this study, it was not appropriate to develop propositions to validate existing theory (Eisenhardt 1989). This deductive approach would limit the exploratory nature of this study which seeks to understand what and how certain variables are related through an inductive theory building approach.

The case firm chosen in this study is a large multinational manufacturer of electronics components, which we will call Electro. The focal wholly owned subsidiary of Electro is located in an Eastern European transition economy. The case study data was gathered during

the establishment phase of this subsidiary. Electro was chosen due to its appropriateness to answer the research question in this study. This is the first subsidiary that the MNC has established outside the Asian region and in a transition economy. In addition the managing director in charge of subsidiary operations has never been involved in the establishment of a subsidiary in a transition economy prior to this appointment. Given that operating in a transition economy is relatively new to the managing director and the multinational corporation headquarters, the challenges and impact of these on MCS choices should clearly emerge from the case data. As challenges are realised it is expected that MCS choices are chosen accordingly. Therefore variation and evolution of MCS choices is expected to occur as these challenges are realised, providing a rich source of data for this study.

The data was collected through a series of interviews, primarily with the managing director of the subsidiary and direct site observations at subsidiary facilities in the transition economy. The interviews and site observations took place in 2000. Given the ongoing process of transition in many Eastern European countries, the data gathered is relevant within the current general economic and operational context of transition economies. The interviews were semi-structured to guide questions asked, rather than asking a list of predetermined questions. The objective was to identify key challenges and explore the impact on MCS choices, so structured interviews with set questions concerning specific constructs was not appropriate in this circumstance. All data gathered was analysed and organised to ensure that a coherent pattern of results emerged. Data throughout the interview transcripts was reconciled to check and ensure consistency. Interpretations of interviewee comments and answers were followed up to check the accuracy of interpretations.

4. Results

This section details the challenges that the multinational headquarters faced when controlling from a distance and the management control system choices exercised to address these challenges. Before these results are presented, we provide some background information on the case firm.

At the time the case study data was gathered, Electro was a rapidly expanding entity in which the headquarters were located in a South-East Asian country. Before the establishment of the subsidiary in the Eastern European country, Electro had started and was operating a number of the other wholly owned foreign subsidiaries. The headquarters of Electro aimed to establish an integrated global network of subsidiaries to supply electronic

components to customers on a global scale. Many of Electro's current customers are multinational corporations, therefore by establishing a global network of subsidiaries Electro aims to cater for the global components needs of these customers. The subsidiary is the first to be established in Europe, in an effort to make headway into the European market by taking advantages of subsidies made available by the host country for new manufacturing ventures.

Electro has expanded aggressively, with the company only starting two years before establishing the subsidiary. Already Electro has established three wholly owned subsidiaries outside its home country in the Asian region, with several hundred million dollars invested in this global expansion. Despite the apparent experience Electro's headquarters has in the control of wholly owned subsidiaries during establishment, it is important to note that all this experience is centred in the Asian region by a primarily South-East Asian staffed headquarters. The management structure of Electro and the subsidiary is shown in Figure 1. Given the significant distance between Electro's headquarters and subsidiary operations, management control system choices previously used may not be appropriate to affectively control this entity. The choice of appropriate management control systems exercised from the headquarters perspective appears important given the competitive nature of the electronics supply market. Efficient operation of such entities is critical since major customers which buy a significant proportion of total output, can purchase similar if not identical components from other supplies. Accordingly these customers use their buying power to drive down prices and can easily switch to an alternative supplier if the prices or quality levels are not satisfactory.

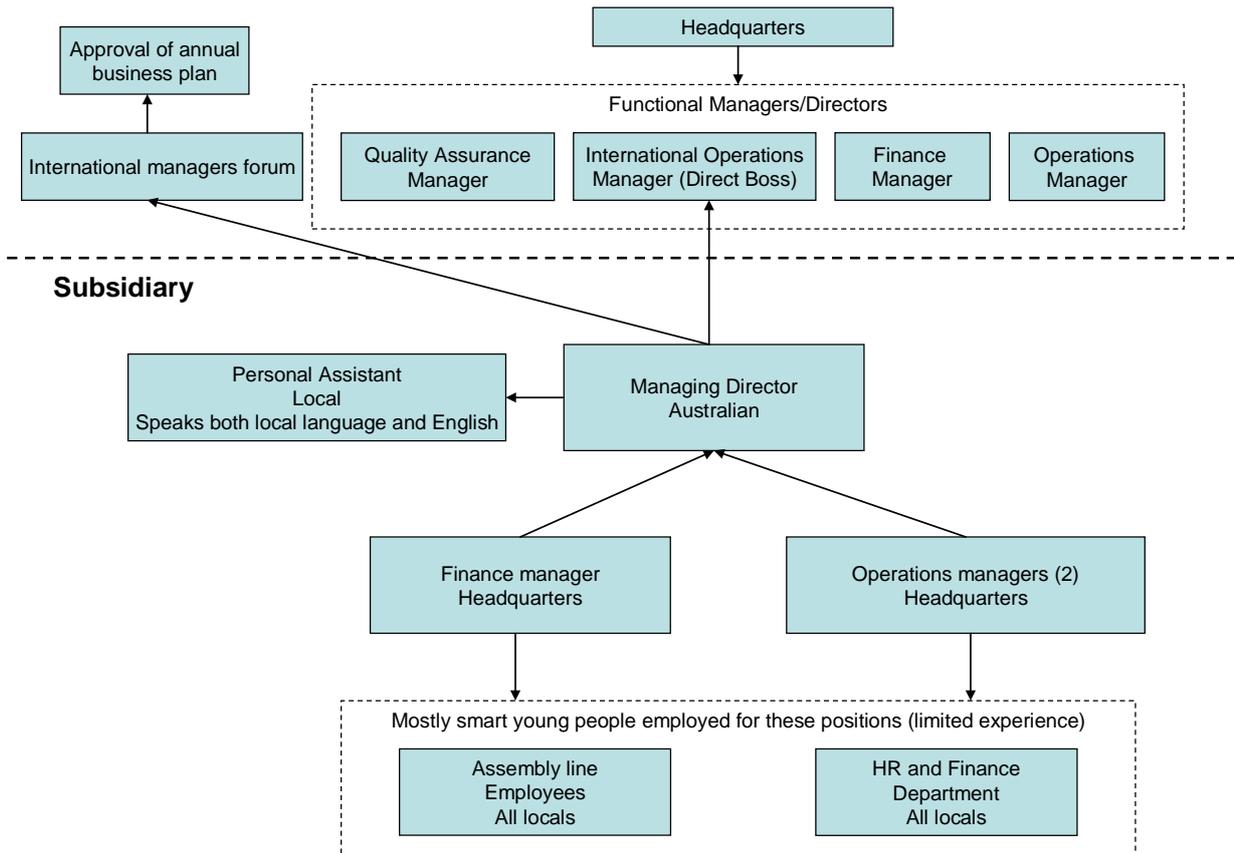


Figure 1: Management structure

Lack of External Integration

Challenge

A key area of concern for the Electro headquarters is the lack of the foreign subsidiary's integration into the Eastern European country business environment. This concern stems from the short time the subsidiary has been in operation, being only eight months and the lack of previous experience concerning operations in the European market. Headquarters have existing business relationships with global multinational customers in the Asian region which it leveraged when establishing in the European market; *“they (major customers) come to us and say, we need supply in Europe, we (Electro) have only got operations in Asia though, so we (Electro) should expand elsewhere”*. However the relationship with local enterprises including both customers and suppliers is extremely limited.

Lack of external integration is a challenge due to the significant dependence Electro's foreign subsidiary has on a large multinational electronics manufacturer which purchases the

majority of the subsidiaries output. This customer is not only extremely price and quality sensitive, but purchases near identical components from other manufacturers in the European region. Accordingly it was easy for this customer to easily switch suppliers if desired. According to the managing director of the subsidiary the plan is to gain new customers, achieving greater external integration and therefore reduce the dependence on one key customer. However given the subsidiary is still in the establishment phase, with production not at full capacity, and systems and procedures still being setup and finalised, there is limited resources available to gain further customers and achieve a higher level external integration at this stage. Therefore the subsidiary is focused on satisfying the one large customer in the short term according to the managing director; *“my focus this year is going to be on building our capability and making sure that we satisfy Customer X’s demand. I am going to go out and do some marketing and try and find more customers but primarily I will be focusing on Customer X”*. This means that the management control systems choices of the Electro headquarters appear essential in coping with this challenge and the associated risks of low external integration.

Effect on Management Control Systems

The electronic component market is very price sensitive, with customers easily able to substitute products from one supplier for another; *“they have got three of us (suppliers), three contract manufacturing companies, so they can leverage one of us against the other ones”*. The main customer of the subsidiary is very price sensitive and provides little opportunity for negotiation; *“we essentially have limited bargaining power, our main focus is on cost. Basically, Customer X pretty well dictates to me that this is the cost and this is what they are willing to pay”*. The minimisation of cost, while maintaining an acceptable quality level is important so that the Electro headquarters can minimise the risk of the current lack of external integration, in terms of both customers and suppliers, and be in a position to expand the customer base in the future.

There appears to be significant use of results controls by Electro headquarters over the subsidiary. The subsidiary is required to prepare an annual budget, including sales revenue and expenses. This specifically entails estimating unit sales, revenue per unit and associated expenses. Given the competitiveness of the electronics component market and consequent tight margins, accurate estimation and planning of revenues and expenses is critical; *“so essentially, my focus has got to be on managing my cost, taking control of them”*

(subsidiary managing director). The annual budget is presented at an international manager's forum by general managers of Electro's subsidiaries and is then reviewed and approved by the board. Electro headquarters closely monitors the performance of the subsidiary through monthly income statements, required in standardised format so that they are easily interpreted by functional managers at the headquarters level. These reports are prepared by a headquarters expatriate financial controller located at the subsidiary, in order to ensure close contact and clear communication regarding the financial performance of the subsidiary with the headquarters. The heavy use of results controls allows the headquarters to closely monitor financial performance and take rapid corrective action if necessary to minimise the risk and challenges of low external integration.

The use of results controls also extends to product quality. Given the competitiveness and homogeneity of the electronics component market in which Electro operates it is important that a sufficient level of product quality is achieved. Producing components at appropriate quality levels is necessary to maintain and expand the current customer base of the subsidiary, allowing it to cope with the current low level of market integration and expand it in the future. The major customer of the subsidiary has already undertaken its own extensive testing of quality, highlighting its importance. Assurance over quality levels is provided through the use of ISO audits. In addition the quality manager from the Electro's headquarters comes out to the subsidiary every quarter to inspect operations and ensure quality is at an acceptable level.

There is very little use of action controls by the Electro headquarters over the subsidiary, however there is preaction reviews over the unit prices charged to customers. The managing director of the subsidiary is required to obtain approval from the international operations managers at the headquarters before any contracts with customers are finalised; *“essentially I have just gone through the negotiation process with Customer X about what we are going to charge them per unit, but I referred back to my direct boss to say ‘look, this is what I think’, and he determined whether the price is appropriate”*. The price sensitivity of the customers and the associated challenge of the limited customer base, appears to be the primary reason for the use of this action control.

Cultural Differences

Challenge

A major challenge of operating the subsidiary is the cultural differences between the headquarters and subsidiary local employees. This challenge is further complicated by the lack of prior experience of Electro in the transition economy. The local employees appear to have a preference towards autonomous teams to achieve tasks and goals; *“they would prefer if I said ‘as a team, this is what needs to be done’, and they will work out amongst themselves who is going to lead it and how. The team would have ownership”*. Not only do the employees appear to favour working as a team but also being acknowledged and rewarded as a team. Significant animosity was directed towards the managing director when he congratulated a particular divisional team (team X) for passing a ISO audit, when the wider workforce felt they also deserved praise; *“I got some feedback the next day from a couple of other people saying they are very angry, very upset with me because they felt they put as much in into it as team X. And when I was seen talking to them over dinner, people said ‘look, the way you approach things around here is through teams”*. According to the managing director there has been significant issues between the headquarter managers and local employees; *“had a lot of incidence where there has been a lot of friction between the way headquarter’s representatives come here and say ‘look, just do it this way, don’t ask questions about why. Just do it’, and you know, the locals aren’t like that. They don’t just accept that. The experience we had, or I think it’s the headquarter’s representatives had in China for example was very you know, ‘just do it’, but here it hasn’t work that way and the locals are very proud of what they do and they want to take ownership of the thing”*. The unique management control systems utilised by the Electro headquarter appear necessary to cope with the challenge of differing cultures.

Effect on Management Control Systems

The use of personnel controls appears to be the primary means Electro headquarters copes with the unique cultural characteristics of the Eastern European country setting during the subsidiary establishment phase. The headquarters has deliberately selected a managing director that they perceive has an understanding of both South-East Asia and Eastern European cultural characteristics; *“I have been the mediator (between headquarters and subsidiary operations), and that has been one of the biggest challenges. I think the directors*

have a deliberate ploy to actually get a non-Asian manager". It appears the Australian managing director, is purposely selected to form bridge between the South-East Asian headquarters and Eastern European operations. This is particularly critical at the subsidiary level, where there is a mix of both expatriates filling subsidiary management positions and local employees filling manufacturing and administrative positions. This mix of employees means that it is critical that tensions and cultural differences are managed; *"In places like China, you can tap somebody in the hand and say 'no, you are not doing it right', but you can't do that here.. So, it was quite a clever thing I think for the directors to accept that, that probably a Westerner (managing director) was better suited to come here"*. It appears that to effectively control the subsidiary in the establishment phase in a transition economy, where the headquarters has little experience, the use of personnel control through appropriate selection is critical.

The Electro headquarters considers their ability to tightly control the subsidiary from a distance through action controls is limited due to the cultural challenges. Accordingly the only action controls used by the headquarters are financially related, with full autonomy extended to the subsidiary managing director in terms of operational actions and decisions; *"I've got complete autonomy in terms of, layout of this place, the hiring and firing of everybody here. I have got complete autonomy"*. It appears that action controls are being substituted by the use of personnel controls from the headquarter perspective, in particular selection and placement.

The subsidiary operations is still in the establishment phase so as a result all the management control systems that may be used by headquarters are not in place. The preference of local employees towards autonomous teams, rather than a more hierarchal management structure may have important implications on the future management control system choices of headquarters. According to the managing director, in the medium to long term it is aimed to have the subsidiary fully staffed by local employees, including the managing director's position; *"that is a deliberate strategy that the company (Electro) has adopted in that we want to minimize the number of expatriates (from South-East Asia) and maximize the number of locals.....The intent is that at the end of my three years here, I would have groomed a local person to take over my position (managing director)"*. Based on the headquarters current experience this suggests a focus on the use group based rewards, given the significant animosity directed towards the managing director when particular employees or subgroup are singled out for reward. Further it would appear that the use of

results controls to monitor performance would be more applicable, rather than the use of action controls undermining much of the autonomy of subsidiary employees.

Recruitment of Suitably Qualified Employees

Challenge

The transition economic environment in which the subsidiary operates meant that recruiting employees for assembly line, administrative and management positions was a challenging process. Finding appropriately qualified employees for management positions appeared the most challenging. While the managing director of the subsidiary acknowledged that the education system in the Eastern European country is relatively strong and equipped the workforce with necessary skills and knowledge, finding candidates with sufficient experience was considerably more difficult; *“I have interviewed a lot of people for these key positions, but it is very difficult to find people that have the other kinds of industry backgrounds as well as a good solid and general background. So, to date, I spend a lot coordination effort, a lot of time ensuring that people understand what their requirements are and the people we have recruited are all fairly young people. So whilst they are smart, they don’t yet have enough experience”*. The transition economic environment of the host country means that there were few manufacturers producing similar products to Electro’s, and as a result there is few potential candidates with relevant experience to fill specific management positions. In addition even if suitable potential candidates were available, finding these people was difficult since. This is due to the lack of a well established means of advertising and/or recruiting experienced staff, due to the recent move way from a centrally planned economy.

Effect on Management Control Systems

A contrasting characteristic between the subsidiary and competitor firms in the host country is the aim to staff it completely by locals, including all management positions. Many of the competitors appear to staff all management positions in their foreign subsidiaries with expatriates from the home country of their headquarters. While many of the management positions in Electro’s subsidiary are currently staffed by representatives of headquarters, the aim is to substitute them with locals as soon as practical. This is to be achieved by training and development of younger front line employees that are appropriately educated, but do not

possess the necessary experience and skills to fill management roles. Accordingly employees at the subsidiary can see the opportunity for promotion, in contrast to other competitor foreign subsidiaries where there appears to be a glass ceiling for local employees; *“I understand that now a number of other Asian companies have found it quite difficult to continue successful operations, because they rely too much on expatriates to fill top management positions who lack the necessary local knowledge and experience, and people just don’t see a path”*. The use of personnel control through training and development of employees appears critical to addressing the challenge of findings suitability qualified employees in the medium term and also motivating employees through future career opportunities. In this regard this also may improve retention of employees and consequently lower staff turnover.

Lack of Experience

Challenge

The headquarters lack of experience in operating a foreign subsidiary in Eastern Europe has led to a number of challenges and issues primarily centred on communication. Electro was not able to recruit any of the managers during the establishment phase who were familiar with local culture or proficient in the local language. As a result, none of the expatriate managers or the Australian managing director can speak the local language. Heavy reliance is placed on translators for communication with the local workforce. It appears that in hindsight greater efforts could have been made by the headquarters to train expatriate managers in language skills, which is particularly emphasised by the managing director; *“If I was to start all over again, I would have devoted more energy in learning the language”*. The limited ability to effectively communicate with the local workforce has caused tensions between management and local employees, particularly when conveying information and directives from headquarters. This has also caused difficulties in understanding the local cultural characteristics, in terms of acceptable and unacceptable work practices. The following quote from the managing director illustrates this:

“cultural and communication issues are the biggest challenge. I’ll give you an example..... the timing issues of recruiting people and setting up the infrastructure. We recruited the people probably too earlyso we end up of having many labourers sitting around for a long time, for about 2 months. And what we did over Christmas, gave them a

bonus, which is supposed to be linked to productivity and quality. I gave their bonus based on goodwill gesture, you know, and then came January and February and they said `well, ...' And I said `well look because we haven't started operations, you know, we can't really afford to give you a bonus', and sort of gathered everybody into the canteen and explained to them the situation. I made a mistake of saying `look, if you don't like it, then you don't have to stay here'. The next day, they went to trash the toilets. I guess I sort of learnt a lesson there that you can't necessarily say that kind of thing in this country. I did not expect that sort of reaction. The biggest challenge is dealing with the local culture.....”.

This indicates that it is critical for headquarters to exercise appropriate management control systems to address the challenges associated with communication and understanding issues.

Effect on Management Control Systems

The communication issues mean that utilising tight action controls from the headquarter perspective is not appropriate, given the difficulty in relaying directives to local subsidiary employees. That is why, in this case, there are limited action controls exercised by the headquarters. Rather than relying on action controls, there is a significant emphasis on results controls use, through monitoring performance of the subsidiary on a relatively constant basis. All financial reporting for the subsidiary is bilingual, in both English and the host country language. This allows the expatriate financial controller to clearly communicate financial performance of the subsidiary to the headquarters. In addition operations and quality managers from headquarters regularly visit the manufacturing facility to check on operations.

To address the present challenge of communication, the headquarters has filled a large proportion of positions with locals and is in the process of training local employees to fill management positions in the future. Appropriate monitoring of the facility through financial and quality reporting should allow the headquarters to extend high autonomy to the subsidiary in the future when it is fully staffed by local employees and only intervene if performance does not meet desired standards. This should minimise the communication challenges faced by headquarters.

External Environment

According to literature the external business environment and associated uncertainty appear to be key factors effecting management control system choices. However in Electro's subsidiary, it appears that environmental uncertainty does not play a significant role in this regard. The choice of Electro to specifically establish a subsidiary in Eastern Europe stemmed from low levels of environment uncertainty according to the managing director; *"the main reasons for our presence are government incentives and a stable business climate"*.

Discussion of Results

The results suggest that national culture has a significant effect on the management control system choices of multinational headquarters controlling wholly owned subsidiaries from a distance. The control package exercised over the foreign subsidiary appears in many cases to be primarily driven by culture and the interrelated effect of communication and language challenges. These relatively clear results differ somewhat from the suggestions of extant literature (Chenhall 2003).

In this study we have not adopted a particular method of conceptualising culture given the frequent debate as to whether such conceptualisations including Hofstede and Bond (1988) effectively capture totality of culture (Efferin & Hopper 2007; Harrison & McKinnon 1999). Rather we have allowed the cultural characteristics to emerge from the data. The results suggest that local employees have a preference towards greater autonomy at work, more emphasis on team work and equality in group rewards and acknowledgement. These cultural characteristics appear to drive heavy use of personnel controls through the placement of an Australian expatriate managing director and training of local employees. In addition the use of group based rewards seems more appropriate in this subsidiary setting. The use of results controls appear to substitute for action controls, which are not extensively used.

The significant emphasis on results controls by headquarters appears to primarily stem from the challenges of low external integration and lack of experience when the new subsidiary was established. Both of these factors are regarded as key organisational strengths since greater experience when operating in a market is argued to improve decision making, particularly regarding assimilating to new external information and using it for commercial means (Cohen & Levinthal 1990). Further higher levels of external integration allow greater knowledge absorption and less reliance on a narrow spectrum of entities including customers

in a foreign market (Hansen 1999; Lane & Lubatkin 1998). To cope with deficiencies relating to these two areas of organisational strengths and associated challenges, higher use of results controls allows the headquarters to minimise the risks associated with low external integration and limited ability to provide direction to subsidiary operations due to lack of experience.

A prominent challenge that appears to influence management control system choices of headquarters is the recruitment of suitably qualified employees. Coupled with the cultural characteristics and to a lesser extent lack of experience, it appears that these factors drive personnel controls, in particular selection, training and development. The multinational headquarters appears to be very reliant on personnel controls, extending significant autonomy to foreign subsidiary management. Results controls, instead, are heavily used, particularly through monitoring financial and quality performance indicators. Therefore it appears that management control systems are primarily comprised of results and personnel controls exercised from the perspective of the multinational headquarters. Figure 1 below summarises the key challenges and management controls identified.

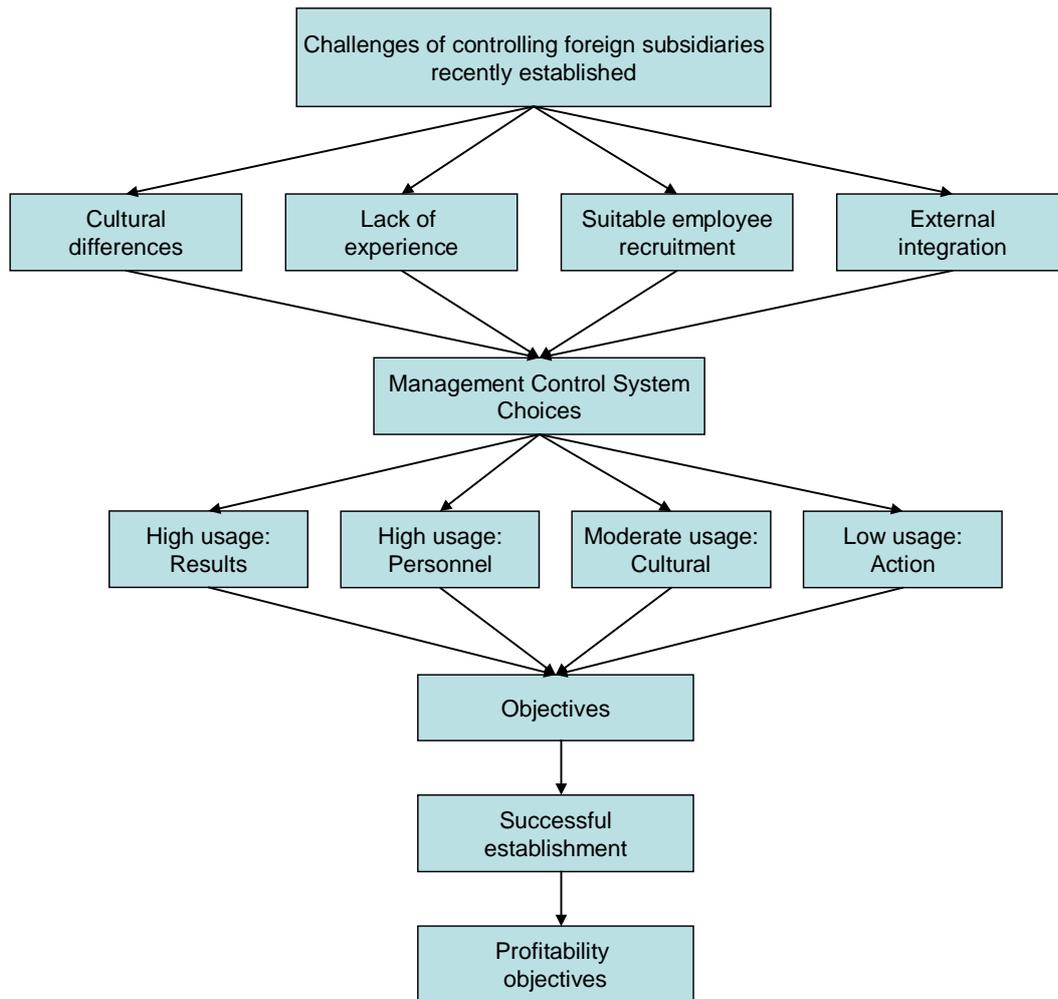


Figure 2: Challenges and associated management control system choices

There appeared to be little effect of external business environmental uncertainty on the control choices during the establishment phase, inconsistent with the suggestions of extant literature (Abdel-Kader & Luther 2008; Agbejule 2005; Bloom & Milkovich 1998; Ezzamel 1990). It appears that the multinational headquarters to date has avoided the challenges associated with this uncertainty through careful selection of the relatively stable business environment in which to establish subsidiary operations. There appears to be significant opportunities in terms of transition and developing economies across Asia and Europe for multinationals to choose when establishing foreign operations. Therefore to minimise the effects of uncertainty, multinational corporations may be choosing more stable locations, suggesting that the effect of this variable on management control systems during establishment in the short term are minimal.

5. Conclusion

This paper discusses and details the results of a case study into the management control system choices of a multinational company over a recently established wholly owned subsidiary in a transition economy. The extant literature offers limited suggestions on management control system choices aimed at controlling wholly owned foreign subsidiaries during establishment. Accordingly suggestions with regard to the effect of challenges in foreign subsidiary context on MCS choices are far from definitive. Given the importance of wholly owned foreign subsidiaries to capitalise on the growing opportunities in developing and transition economies, it is critical to address this gap in literature. In this paper we use Merchant and Van der Stede's (2003) control framework conceptualisation consisting of results, action, personnel and cultural control dimensions to comprehensively investigate the effects of challenges identified.

The results suggest that cultural characteristics, recruitment of suitable employees, lack of external integration and lack of experience are the key challenges faced by the multinational headquarters when controlling from a distance. Unexpectedly environmental uncertainty did not appear to have significant impact on control choices. The challenges faced by the multinational headquarters appeared to lead to the use of results and personnel controls. The recruitment and training of suitable employees to manage the foreign subsidiary and the tight monitoring of performance appears to address the core challenges faced by headquarters. In addition while the use of cultural controls is limited during establishment, it appears that team and group based rewards are appropriate in the transition economy business settings such as those of this Eastern European country. We found limited use of action controls by headquarters during the establishment of the foreign subsidiary, consistent with the higher level of autonomy extended to the foreign subsidiary.

This paper makes a substantial contribution to literature and practice by identifying relevant challenges and how these are addressed through multinational headquarters management control system choices. This may provide decision making guidance to multinational headquarters establishing wholly owned foreign operations in transition and developing economies. However given that the data for this paper was gathered from a single case study, this may limit the ability to generalise suggestions and findings to a broad range of firms. Clearly further investigation and research is required to establish a substantial body of literature and associated theory regarding the headquarters control of newly established foreign subsidiaries in transition and developing economies.

There are substantial opportunities for future research on these settings, particularly regarding the identification and refinement of exactly what are the core challenges faced during establishment in a variety of transition and developing economies, and associated MCS choices. The suggestions from this study indicate two sets of challenges, first contextually based consisting cultural and suitable employee recruitment; second coping with deficiencies in internal subsidiary strength based factors consisting of lack of external integration and experience. Given the focus of literature contextually based factors and challenges (Chenhall 2003), there appears to be limited consideration for deficiencies in subsidiary strengths and a substantial opportunity to address what management control system choices can be utilised to cope with strength deficiencies or maximise the benefits of any strengths held.

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