



UNIVERSITY OF NIŠ  
FACULTY OF ECONOMICS  
"ECONOMIC THEMES"

Year XLVII, N° 4, 2009, p. 113 - 128

Address: Trg kralja Aleksandra Ujedinitelja 11, 18000 Niš

Phone: +381 18 528 601 Fax: +381 18 4523 268

## THE ROLE OF ACCOUNTING IN FOREIGN SUBSIDIARY PERFORMANCE EVALUATION

**Violeta Domanović, Ph.D.\***

**Jasmina Bogićević, M.E.\***

***Abstract:** In order to remain competitive globally, MNCs need to use performance evaluation system which is congruent with the company's mission, objectives, and strategies. Performance evaluation is the key management control task. It provides measures that can be used to evaluate management performance. Corporate management applies performance evaluation system in order to assess the profitability of current foreign operations, identify areas that need corrective actions, and motivate foreign subsidiary staff. The success of a performance evaluation system is determined by its design as well as the implementation of that system. A great number of studies have shown that no single criterion can be used in evaluating the performance of all foreign subsidiaries. MNCs use a mixture of measures, financial and non-financial in order to evaluate performance. Conducted research indicated that three financial measures used by both the U.S. and U.K. MNCs are profit, return on investment, and comparison of budgeted and actual profit. The most important non-financial measures of performance include market share, relation with host government, quality control and productivity improvement. The successful implementation of a performance evaluation system requires the integration with the overall strategy. Performance evaluation system must include comprehensive measures, fair and achievable measure. It is best to use simple, clear and understandable measures. One of most important aspect in the designing of performance evaluation systems was the introduction of the balanced scorecard. It represents creative mixture of financial and non-financial measures. It provides management guidelines for creating shareholder value. Balanced scorecard focuses on integrated relations among the key elements of a business – vision and strategy*

---

\* Faculty of Economics Kragujevac, e-mail: vterzic@kg.ac.rs, jasminabogic@ptt.rs  
UDC 658.15; Review paper  
Received: 23.09.2009.

*and four perspectives, namely financial, customer, internal business process and learning and growth. Corporate management applies performance evaluation system in order to assess the profitability of foreign operations, identify areas that need corrective actions and motivate foreign subsidiary staff. No single criterion can be used in evaluating the performance of all foreign subsidiaries. Multinational companies use a mixture of measures, financial and non-financial in order to evaluate performance. The success of a performance evaluation system is determined by its design as well as the implementation of that system. One of most important aspect in the designing of performance evaluation systems was the introduction of the balanced scorecard. It represents creative mixture of financial and non-financial measures. Accounting plays the most important role in performance evaluation system implementation.*

**Keywords:** *performance evaluation, balanced scorecard, multinational companies, accounting information, foreign currency translation.*

### **Introduction**

Performance evaluation is a complex issue in a domestic context. It becomes much more complex in an international setting. Performance evaluation of foreign subsidiaries must deal with some issues that are unique to global business, such as exchange volatility, varying rates of inflation in foreign countries, international transfer pricing, and environmental differences that exist across countries. Unless these factors are appropriately considered, headquarters may receive distorted pictures of foreign operating results and use inappropriate standards to assess performance. Inappropriate standards of foreign subsidiary performance may encourage managers to take action not in line with corporate goals. Direct consequence is reduced corporate efficiency and competitiveness.

The success of performance evaluation system is determined by its design and its implementation. To be successful, performance evaluation system must be in line with the overall corporate strategies and the local circumstances. Multinational companies strive to achieve superior economic performance in global arena. They need to set up a balanced set of financial and non-financial performance measures to get an accurate picture of the performance of their managers and subsidiaries located in different countries.

There are a great number of factors that must be considered in setting up performance evaluation systems for subsidiaries located abroad. First is the choice of appropriate currency for measuring the performance of

## **The Role of Accounting in Foreign Subsidiary Performance Evaluation**

foreign subsidiaries. The second factor relates to transfer pricing policies. It must be taken into account a number of macro-economic variables, such as different level of inflation, interest rate differentials and differing levels of political stability across countries.

In practice, financial criteria tend to dominate performance evaluation systems. The most important financial criterion used to assess the performance of foreign units is budget to actual profit followed by return on investment. Despite difficulties in measurement, some non-financial criteria are considered important in multinational performance evaluation systems. Market share is the most important non-financial measure of performance.

The most important achievement in performance evaluation system designing was the introduction of balanced scorecard. Contrary to the traditional performance, measurement system, which starts from the financial control as the essence, the balanced scorecard starts with the organizational vision and strategy. There is a tendency to translate these vision and strategy into performance measures, which could be tracked and used for the success measurement in the vision and strategy implementation process. These could be achieved by defining the aims and measures into the each of the four interrelated perspectives of the balanced scorecard: finance, customers, internal process and learning and growth.

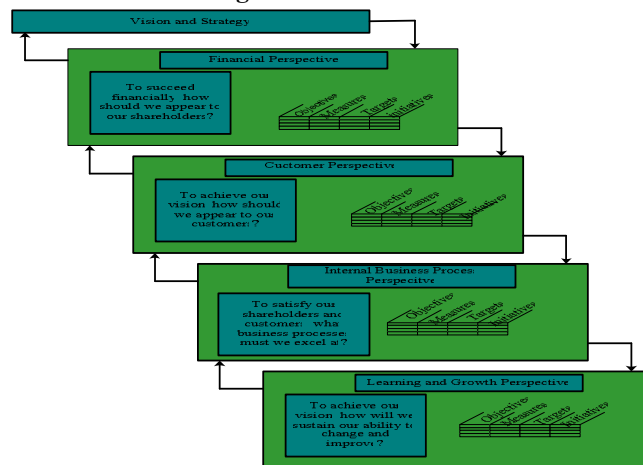
The main point of this paper is how to assess performance, but especially foreign subsidiary and what the role of accounting in such a process is. Thus, the paper is structured into two parts. The first part is devoted to the mere balanced scorecard model, that is its postulates and role and the other one is devoted to the key role of accounting information in assessing foreign subsidiary performance. Besides, there are considered some obstacles in this process that are inherent to the multinational company.

### **1. The Role of the Balanced Scorecard in Assessing Foreign Subsidiary Performance**

Performance measurement is the most important element in the enterprise economy system. It is too complex process for each company, not to talk about multinational ones. Namely, multinational companies strive to achieve superior economic performance in global arena. They need to set up a balanced set of financial and non-financial performance measures to get an accurate picture of the performance of their managers and subsidiaries located in different countries.

In modern business environment, the traditional performance measurement system is necessary but not sufficient one. This is because of the fact that modern business environment has suffered many changes and forces the companies to undertake emergent actions. The most important achievement in the design of performance evaluation systems was the introduction of the *balanced scorecard*. A balanced scorecard focuses on an integrated relationship among the key elements of a business – vision and strategy and four perspectives – finance, customers, internal business processes and learning and growth. This performance measurement model has been very popular in latest years either in positive or negative sense. The question is if it is in essence something real new, or it is just rhetoric game. Many companies do apply non-integrated performance measurement system. Being an integrated system, the question is what the role of balanced scorecard in performance evaluation at all is and what in MNCs, especially. The basic premise beyond the balanced scorecard is simple. Financial measures are, and will always be important, but they must be supplemented by other indicators that predict future financial success. Starting from this as the basic aim, *Kaplan and Norton* developed the balanced scorecard model (see figure 1-1).

Figure 1-1. Balanced Scorecard Model



Source: Kaplan, S. R. and Norton, D. P. (1996): 'Using the Balanced Scorecard as a Strategic Management System', *Harvard Business Review* (January-February 1996): 76.

For difference from traditional performance measurement system, which starts from the financial control as the essence, the balanced scorecard starts with the organizational vision and strategy. There is a tendency to translate these vision and strategy into performance measures, which could

## **The Role of Accounting in Foreign Subsidiary Performance Evaluation**

be followed and used for the success measurement into the vision and strategy implementation process. This could be achieved by defining the aims and measures into the each of the four interrelated perspectives of the balanced scorecard: finance, customers, internal process and learning, and growth.

### *Financial perspective*

Financial measures are certainly the important element in each company (profit, public and non-profit). In domain of profit organizations, the measures from this perspective tell us if the strategy implementation, which is explained in detailed through the measures from other perspectives, leads to the better final results. In non-profit and public organizations, financial measures provide results to be achieved, but so that costs are to be minimized. Here, we have lagging indicators like: revenue, profitability and assets use, and the key questions is: how should we appear to our shareholders? Profit-oriented companies tend to increase the shareholder value. This could be happened in two ways: revenue growth and productivity growth. For foreign subsidiaries, the most important financial measures are sale growth, cost reduction, profit, and return on investment.

### *Customer perspective*

The core of any organization's strategy is the value proposition for customer, which describes mix of product, price, service, relationship and image that a company can offer. The value proposition defines how one organization differentiates from the competitors to attract, retain and improve the relationships with the target customers.

In the process of selecting the measures from the customer perspective, organizations must set two critical questions: "Who are our target customers?" and "Which is our value proposition in serving the customers?" It sounds too simple, but both of these questions offer many challenges. Here, organizations may choose among:

- Business excellence, which implies low prices, reliability and often "has no extra attributes",
- Product leadership, which implies constant innovation and best product on the market;
- Customer intimacy, which implied building the long-term relationship with the customers through getting deeply known with their needs.

Multinational companies tend to adapt themselves to the local markets, so the measures from this perspective are very important. Foreign subsidiaries certainly have to take care about the customer needs, their preferences, so that they could increase sale, revenue, market share and profit as the primary motive of their functioning. The very important issues from this perspective are if their customers are satisfied and if not what they should do, that is how to act, in order to attract and retain customers, that is what they should do that customers become loyal in future.

*Internal business process perspective*

In this perspective of the balanced scorecard, there are identified the key processes in which a company must excel at so it could continue with adding value for customers. In order to satisfy the customers, an organization must identify complete new internal processes instead to focus its efforts on incremental improvements of the existing activities. The development of the service and delivery, partnership with the community and reporting are the examples of some elements which could be presented in this perspective.

The internal business process perspective encompasses these critical organizational activities, which belong to the four processes on upper levels [3, p. 93]:

- Building the franchise stimulating the innovation to develop new products and services and to penetrate to new segments of market and customers.
- Increase value for customers expanding and deepening the relationships with the existing customers.
- Realize operating excellence, improving supply chain management, internal processes, assets use, resource capacity management and other processes.
- Become good corporative citizen establishing the efficient relationships with external interested groups.

Foreign subsidiaries especially should accommodate their products and services to the local customers' tastes. There are certain specificities in respect to the relationships with the external interested groups (cultural, sociological, psychological, linguistic, religious, political, and economic). The financial benefits from improving different business processes typically are being realized in phases. The costs savings from increasing business efficiency and process improvement deliver short-term benefits. The revenue growth from improving the customer relationships is being realized in medium term. The increasing innovation rate generally leads to the

### **The Role of Accounting in Foreign Subsidiary Performance Evaluation**

improving the long-term revenue and profit. Thus, the complete strategy should generate return on all three levels of the internal processes.

#### *Learning and growth perspective*

The measures from learning and growth perspective enable the other three perspectives. In essence, these are the base on which the whole balanced scorecard house is built.

Once, when the measures and related initiatives from customer and internal business process are defined, it is possible to reveal some gaps between current organizational infrastructure of the employees' qualifications (human capital), information systems (information capital) and climate (organizational capital) and the level which is necessary to close the gap and it provides the sustainable results in future.

Similar to other perspectives, it is expected to get a mix of the core results and efficiency drivers so the learning and growth perspective could be presented. For an example, the staff qualifications, employee satisfaction, information availability etc. may have the significant role in this perspective.

Human capital is of special importance in the company efficiency. Unfortunately, this is in collision with the fact that foreign subsidiaries use cheap local labour force. The question is if they are satisfied and motivated to improve efficiency, and how this is resolved in practice. No matter how much it is cheap for foreign subsidiary, the employees are satisfied if their salary is higher than the average one in domestic economy.

Since the late of 1990s, almost all main companies expanded their business chain, supply chain, services served to the customers and employees including and internet. At the same time, it is created the discipline Web analytics in aim of measuring the influence of Web based initiatives. Web analytics is the data analysis from the web site so the web site success could be determined and customers' behaviour understood. With this information, the company may collect the data of customers' preferences, feedback and demographic data, which could be of help in generating the higher revenues and lower costs.

Successful companies strive to connect their present activities with the tomorrow aims – not with the yesterday performances. The company has to make the mix of traditional performance measures, to support with Web analytics and connect with vision and strategy so it could be created a holistic sight on organization.

The technology change, which is more and more massive, does not mean abandoning the traditional management concepts. It is actually

accommodating the traditional business principles on transformational world of internet. Such a consideration has led to the extension of the traditional balanced scorecard with two new dimensions, which include Web analytics – electronic business perspective and user perspective. Both these dimensions support two of four original dimensions.

The electronic business perspective connects in traditional balanced scorecard the tasks in customer and finance perspectives and is focused on increased profits and market share. This perspective includes the metrics, which measures as well as financial as the influence of the market penetration linked with the users' interaction with Web based technologies. The user of Web based systems may be that who has a contact with this system, including external buyers, internal employees and suppliers and partners. When the metrics in electronic perspective is developed, it should be analyzed the process types, which are set for the Web based initiatives and their basic intention.

The user perspective supports the internal and learning perspective in traditional balanced scorecard, focusing on experience of users and technology performances. In metrics selection for this perspective, it should be focused on processes that improve company efficiency and the way the users evaluate them.

However, the prerequisites and philosophies that lay in base of these balanced scorecards are completely different from those lying in the base of strategic balanced scorecard. In practice, there are often two types of the balanced scorecard to be applied: stakeholder scorecard and key performance indicator scorecard. Namely, the balanced scorecard may be viewed from many aspects. It may be an effectiveness measurement model, efficiency measurement model or strategic performance management model. Of course, the way one will consider the balanced scorecard depends on defined aims and objectives.

The balanced scorecard should not be just a collection of financial and non-financial measures, organized into three or four perspectives. The best one reflects the organization strategy. The good test is if the strategy could be realized watching just this balanced scorecard or strategy map. Many organizations do not pass this test, especially those which create the stakeholder scorecards or key performance indicators scorecards.

The strategic balanced scorecards together with graphical presentations on strategy maps supply a logical and understandable way of strategy description. These clearly communicate the desired results and hypotheses about how to achieve these results. For instance, if a company is



### **The Role of Accounting in Foreign Subsidiary Performance Evaluation**

to improve the delivery on time, then customer satisfaction will increase, and then the customers will buy more and more. These balanced scorecards enable all organizational units and employees to understand strategy and identify how they can contribute to the strategy realization.

Here, the term *balanced* is especially interesting. This means a balance among [5, p. 22]:

- Financial and non-financial performance indicators. Balanced scorecard originally is directed toward overcoming the disadvantages of relying on financial measures balancing them with the drivers of the future results. This remains as a main principle of the system.
- Internal and external constituents. Shareholders and customers represent the external constituents who are explained in the balanced scorecard while employees and internal processes represent the internal constituents. The balanced scorecard recognizes the significance of the balancing the temporarily contradictory needs of all groups in order to implement strategy efficiently.
- Lagging and leading performance indicators. The lagging indicators represent the past results. Typical examples can include the customer satisfaction or revenue. Although these measures are usually completely objective and available, the lack is a predictive power. The leading indicators are the result drivers which lead to the realizing the lagging indicators. Delivery on time may present the leading indicator for the lagging measure of the customer satisfaction. Although these measures are considered to be predictive by its nature, the correlation may show that they are subjective ones. The balanced scorecard should combine the lagging indicators with the leading ones. The lagging indicators without leading measures do not tell us about that how the aims could be achieved. Conversely, the leading indicators without lagging measures can demonstrate the short-term improvements but do not show if these improvements led to the better results for the customers and finally shareholders.

### **2. The Role of Accounting Information in Foreign Subsidiary Performance Evaluation**

Performance evaluation is a complex issue in a domestic context. It becomes much more complex in an international setting. Performance evaluation of foreign subsidiaries must deal with some issues that are unique to global business, such as exchange rate volatility, varying rates of inflation

in foreign countries, international transfer pricing, and environmental differences that exist across countries. Unless these factors are appropriately considered headquarters may receive distorted pictures of foreign operating results and use inappropriate standards to assess performance. Inappropriate standards of foreign subsidiary performance may encourage overseas managers to take action not in line with corporate goals. Direct consequence is reduced corporate efficiency and competitiveness.

The success of performance evaluation system is determined by its design and its implementation. To be successful performance evaluation system must be in line with the overall corporate strategies and the local circumstances. Setting up an effective performance evaluation system for subsidiaries located in other countries requires decisions with regard to:

- (1) The performance criteria;
- (2) Distinguishing between subsidiary performance and manager performance;
- (3) The treatment of the foreign operation as cost, profit or investment centre;
- (4) Understanding issues specific to companies engaged in global business, such the choice of appropriate currency, transfer pricing policies, differing levels of inflation and political stability across countries.

Multinational companies must decide to use financial criteria, non-financial criteria, or some combination of the two to measure and evaluate performance. Both financial and non-financial criteria are used for the evaluation of the performance of overseas unit and subsidiary manager. Financial criteria tend to dominate performance evaluation systems. They include sales growth, cost reduction, profit and return on investment (ROI).

Several surveys conducted in United States and in the United Kingdom have attempted to determine the importance of these criteria. Both U.S. and non-US multinational companies indicate that the most important criterion used to evaluate the performance of foreign units are profit, return on investment and budget compared to actual profit (reported in Exhibit 1) although the rank order changes slightly among the four studies.