

# THE IMPACT OF CULTURAL DISTANCE ON THE PERFORMANCE OF FOREIGN SUBSIDIARIES: EVIDENCE FROM THE KOREAN MARKET

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**Abstract.** *This study investigates whether the cultural distance between Korea and the home countries of foreign subsidiaries in Korea affects the subsidiaries' financial performance. It contributes to the literature on international business in that it sheds light on cultural distance, a well-established but somewhat neglected concept in international business. Unlike most of the previous studies that have used cultural distance as a control or moderating variable, this study uses it as an independent variable in the context of globalization through foreign direct investments in Korea. Focusing on the possible positive side of broad cultural distance, we hypothesize that the performances of foreign subsidiaries are likely to be better when the cultural distance between their home countries and Korea increases. To test our hypothesis, we have conducted an empirical analysis, using data collected from 472 foreign subsidiaries doing business in Korea. The results support our argument that cultural distance has a positive impact on financial performance. This study finds that having cultural similarities with a foreign market does not guarantee success. Instead, it shows that firms can gain opportunities when incorporating in a foreign national market with broad cultural distance.*

**Key words:** *cultural distance, foreign subsidiary, globalization, firm performance, Korea*

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## Introduction

Cultural distance is a well-established concept, representing the degree of cultural differences between countries, and it has been used in international business studies (Shenkar, 2001; Evans & Mavondo, 2002; Sousa & Bradley, 2006) to measure such areas as the expansion of foreign investment, the performance of foreign subsidiaries, and the selection of entry modes using diverse approaches (Shenker, 2001). The existing studies show that when the cultural distance is significant and similarities in the countries' cultures are low, the overseas performance of global companies is poorer (Li & Guisinger, 1991; Simonin, 1999; Dow & Ferencikova, 2010). Recently, Beugelsdijk, Kostova, Kunst, Spadafora & Van Essen (2018) discovered that cultural distance has high adverse effects on subsidiaries' performance. These studies posit that one of the disadvantages of cultural distance is that the language barrier is more substantial than it is for those who have acculturated in the host culture. Some scholars also mention that it is more difficult for foreign subsidiaries to access market information (Simonin, 1999; Dow & Ferencikova, 2010). However, in the age of globalization, such access is becoming easier due to the development of information and communication technologies and the increase in trade volume among countries (Levitt, 1993; Barkema, Bell, & Pennings, 1996). It can therefore be said that the disadvantages (including lack of understanding of market mechanisms that vary among countries according to the extent of their market globalization and language differences) are becoming weaker (Stottinger & Schlegelmilch, 1998). In a related vein, there are studies showing that companies perform better when the difference in culture between countries is greater (Hu & Chen, 1996; O'Grady & Lane, 1996; Morosini, Shane, & Singh, 1998; Li, Lam, & Qian, 2001; Evans & Mavondo, 2002). In one instance, proactively dealing with cultural distance offsets the disadvantages because cultural differences brought advantages, such as new routines and a broader repertoire, to the organization (Morosini et al., 1998). Markets are also becoming increasingly globalized and many multinational enterprises are entering foreign markets with well-calibrated business expansion strategies. In addition, products and consumer needs are becoming standardized, and the concept of borders between countries is fading (Levitt, 1993).

Under these contexts, it is interesting to empirically explore whether the concept of cultural distance is still a critical variable in explaining the performance of companies entering overseas markets. Because globalization is accelerating, it is essential to explore how cultural distance affects firm performance, given that culture has a critical influence on people's attitudes, motivations, behaviors, and personalities. Thus, we believe this empirical study can make an important contribution, both academically and practically.

Conducting an empirical analysis of 472 foreign subsidiaries in Korea, this study investigates whether the home to host country cultural distance affects the financial performance of overseas operations. Selecting countries for foreign direct investment

(FDI) is a key issue in the sense that each country has a unique cultural background. The result of this study, evaluating the relationship between cultural differences among countries and the performance of foreign subsidiaries, can provide practical guidance for companies willing to make efficient FDI location decisions.

## **1. Literature Review and Hypothesis**

### ***1.1. FDI in the Korean Market***

Firms are choosing FDI as a form of globalization (Chang & Rhee, 2011). The concept of FDI is different from portfolio investment, which seeks to trade profits with a short-term purpose. In this paper, FDI refers to an investment in which a foreign organization establishes a highly committed relationship with legal entities in Korea or companies run by Koreans. This type of investment is based on Korea's Foreign Investment Promotion Act. According to the Ministry of Trade, Industry, and Energy's "Foreign Direct Investment and the Result Report in 2014," in 2014, FDI in Korea reached a reported \$19 billion, of which \$11.52 billion actually reached Korea. The \$11.52 billion was the highest FDI ever reported, breaking a 15-year record that had existed since 1999, and it represented a year-on-year increase of 17.1% (\$9.84 billion).

Because government regulations had previously been strict, and the government did not actively attract foreign investment, until the late 1990s, the inflow of foreign capital was low in relation to the country's economy. However, since the 1997 foreign currency crisis, after which the Korean government began to focus on attracting foreign capital, FDI has consistently and dramatically risen. According to Statistics Korea, the total FDI inflow into Korea from 1962 to 1997 was \$24.6 billion; from 1998 to 2007 it was \$112.6 billion.

The reasons for foreign investment vary. Developing countries use FDI to transfer technologies and attract more foreign capital. Developed countries use it for other purposes, such as cheaper labor market access and product market expansion (DeMello Jr., 1997). Globally, the amount of FDI is on the rise (Barrell & Pain, 1997). The top 10 FDI investors in Korea are (in a descending order) the United States, Japan, the Netherlands, Luxemburg, Singapore, China, Hong Kong, Canada, Ireland, and the United Kingdom. Except for the African continent, investor countries are evenly distributed across all continents. Thus, the diversity and distribution of FDI in Korea makes it especially suited to empirical analysis of the relationship between the cultural distance of the home and host countries and FDI performance.

### ***1.2. The Concept of Cultural Distance***

Culture permeates human behavior and reflects values and judgments distinguishing right from wrong, beauty from ugliness, and collective from individualistic beliefs (Hofstede, 1984a). Because it is impossible to coordinate the actions of people with-

out understanding their values, beliefs, and expressions, the activities of management are affected by cultural context (Hofstede, 1984a, 1984b). Culture influences individuals and business operations and can be categorized based on nationality (Hofstede, 1984a). Hofstede (1984a) defines culture as follows:

*...culture is the collective programming of the mind which distinguishes the members of one group or society from those of another.*

According to Hofstede (1984a, 1984b), there are four dimensions to national culture: power distance, uncertainty avoidance, individualism, and masculinity. Individualism refers to whether an individual's perspective is "I" or "We," indicating the degree of interdependence between the individual and the society. This dimension fundamentally concerns whether individuals in a society bond more with themselves or with their families. In each, relationships are formed within social frameworks that are relatively loose. Power distance is the extent to which social members accept inequalities that exist within an organization. What matters in this dimension is how a society handles inequality when it occurs among people. Uncertainty avoidance is the degree to which members of a society feel uncomfortable with uncertainty and ambiguity. This dimension essentially reflects how members of society respond to future uncertainty. Finally, masculinity refers to a society's preference for achievement, initiative, heroism, and material success. Femininity can be contrary to masculinity when it indicates a preference for relationships, humility, consideration of the weak, and quality of life. The central matter addressed by this dimension is the way in which society assigns social gender roles.

Hofstede's (1984a, 1984b) framework is widely used in studies of international management concerned with differences between countries (Sousa & Bradley, 2006). Based on his four cultural dimensions, cultural distance is defined as the degree of difference in cultures between countries (Kogut & Singh, 1988). Once the concept of cultural distance was introduced, it became widely used in many disciplines, including sociology and international management. A similarly used concept is psychic distance (Sousa & Bradley, 2006). Psychic distance refers to the degree of uncertainty over the characteristics of foreign markets. It is affected by discrepancies in the language, business practices, and market structures of the host investment country and the home country (Kogut & Singh, 1988). Research by Sousa & Bradley (2006) suggests that there is a significant relationship between cultural distance and psychic distance and that the greater the cultural distance between two countries, the greater the psychic distance between them will be.

### ***1.3. Cultural Distance and Subsidiary Performance***

Research on the effect of cultural distance on performance after foreign market entry uses different variables.

Much research focuses on the cultural differences between countries and the mode of foreign market entry (Kogut & Singh, 1988; Datta & Puia, 1995; Brouthers & Brouthers, 2001; Tihanyi, Griffith, & Russell, 2005). There are also many studies on the effect of cultural differences on the performance of FDI or foreign subsidiaries (O'Grady & Lane, 1995; Hu & Chen, 1996; Park & Ungson, 1997; Li et al., 2001). In studies comparing cultural differences and FDI performance, the results are mixed (Dow & Ferencikova, 2010; Reus & Lamont, 2009). For example, Simonin (1999) concludes that, as the cultural distance in international strategic partnerships increases, ambiguity over transferring marketing expertise becomes higher. A study by Li & Guisinger (1991) on foreign-controlled firms entering the U.S. market shows that, when there are many cultural differences between the parent country and the U.S., there are more failures compared to when the cultures are similar. A study by Dow & Ferencikova (2010) on FDI ventures in Slovakia finds that, as the psychic distance (resulting from differences in industrial development, education, political systems, religion, and language) between the home and host country increases, the performance of FDI grows worse. Other studies exploring the negative correlation between cultural distance and performance explain that the greater the cultural distance, the higher the cost to foreigners. For example, greater cultural distance can generate communication problems caused by language differences. Thus, when entering a new market, language can negatively affect an organization's performance when it results in lack of access to market information and the inability to understand market mechanisms (Simonin, 1999; Dow & Ferencikova, 2010).

There are also studies on the paradox of cultural distance. These studies insist that cultural distance positively affects performance as it grows (O'Grady & Lane, 1995; Hu & Chen, 1996; Morosini et al., 1998; Evans & Mavondo, 2002; Chakrabarti, Gupta-Mukherjee, & Jayaraman, 2009). Hu and Chen (1996) assert that among joint ventures, Chinese companies cooperating with companies in the U.S. (which is culturally much more distant) perform better than Chinese companies cooperating with companies in Asia. In the study of Morosini et al. (1998), the outcomes of company acquisitions from countries with significant cultural distances are better. O'Grady & Lane (1995) contend that being culturally close does not guarantee success in foreign markets. Instead, the assumption is that cultural closeness can disturb the recognition of critical differences and that such ignorance can negatively affect performance. Evans and Mavondo (2002) observe that, as the psychic distance from a foreign market increases, the ambiguity an organization faces becomes higher. To resolve the uncertainty, these organizations expand their research and plans, ultimately improving their strategic choice, and achieving positive results for the organization's performance.

Korea is a country that actively trades with the top 10 countries in both exports and imports. As a result, Korea's FDI has been continuously rising over the past two decades. Increasing international business activities can trigger direct and indirect learning related to institutional and linguistic differences and the unique characteristics of the

Korean market. If potential disadvantages stemming from cultural distance (such as system and language differences) are recognized, then foreign firms can enter the Korean market with expanded knowledge and preparation. Additionally, when exposed to new cultures and environments rather than similar ones, firms may create new repertoires and achieve more significant innovations. Based on these aspects, this study has generated the following hypothesis.

*Hypothesis:* Performance of foreign subsidiaries is likely to be better as the cultural distance between home countries and Korea increases.

## **2. Research methods**

### **2.1. Data Collection and Samples**

To test its hypothesis, this study examines foreign companies that have invested in Korea. According to the Foreign Investment Promotion Act, a foreign investing company refers to a business entity or non-profit organization that foreigners invest in or contribute to in Korea. It must be registered with KOTRA (Korea Trade-Investment Promotion Agency) or KEB (Korea Exchange Bank) as a foreign-capital investment company. The sample used for hypothesis verification was obtained from “A comprehensive survey of companies which expanded overseas in 2012,” published by the Korean Content Media (previously, Mailnet and biz). Korean Content Media is a professional business entity specializing in comprehensive surveys. It distributes the Korean Business Directory published by the Korean Chamber of Commerce and Industry, the Korean Business Directory published by the Korean Listed Companies Association, the Korean Economic Yearbook, and the Business Leaders List published by the Federation of Korean Industries, beginning in 1999 when it acquired the exclusive right to distribute a company yearbook published by the Maeil Business Newspaper. “A comprehensive survey of companies which expanded overseas in 2012” has data on Korean companies expanding their businesses overseas and foreign invested companies in Korea. It provides the business types of foreign subsidiaries, their corporate registration number, date of establishment, number of employees, and category of business.

During the sample selection process, the following cases were excluded: (1) Companies whose financial statements could not be found for a specific year necessary to this study; (2) Companies whose investing countries could not be confirmed by the Ministry of Trade, Industry, and Energy based on the data of foreign capital invested companies; (3) When an investor country could not confirm Hofstede’s Index (e.g., the Cayman Islands); and (4) Countries designated as tax havens by the OECD, such as the Virgin Islands, Bahamas, and Panama, which were registered as investors (OECD report 2000, p. 17: “toward global tax cooperation”).

Based on the above criteria, from a total of 4,387 foreign invested companies, 472 companies were selected as the sample for this study.

## 2.2. The Definition of Variables and Measurement

*Dependent variable.* The dependent variable in this study was the performance of a foreign subsidiary. As an indicator of firm performance, return on assets (ROA) was used. ROA is the ratio derived from dividing a company's annual earnings by its total assets; it is an index of profitability that indicates how a company utilizes its total assets to effectively generate profits. ROA has been used as a dependent variable in many studies to measure the financial performance of corporations (Geringer, Beamish, & DaCosta, 1989; Gomes & Ramaswamy, 1999; Yoon, Kim., & Song, 2016). The ROA for corporate performance was collected from the KIS-Value database of Korea Investors Service Inc.

*Independent variable.* In this study, cultural distance was used as the independent variable by applying the equation of Kogut & Singh (1988). Cultural distance has frequently been used to measure cultural difference in international business settings (Tihanyi et al., 2005; Slangen, 2006; Reus & Lamont, 2009). Kogut & Singh deduced cultural distance between countries by adopting Hofstede's four cultural dimensions. The equation is as follows:

$$CD_{jK} = \sum_{i=1}^4 \left\{ (I_{ij} - I_{iK})^2 / V_i \right\} / 4$$

$I_{ij}$  indicates the cultural dimension index of country  $j$ , and  $V_i$  indicates the variation of the cultural dimension index.  $CD_{iK}$  indicates the cultural distance between country  $j$  and Korea.

*Control variables.* In this study, several factors believed to affect the performance of foreign subsidiaries were selected as control variables. The control variables in this study are: entry mode, the nationality of the CEO, firm size, subsidiary age, industry and previous performance. First, a dummy variable was established to determine whether there was a joint venture. We referred to the research where the ownership structure affected the activities and performance of an organization (Woodcock, Beamish, & Makino, 1994). Based on the research finding that the nationality of a CEO could affect the performance of a multinational corporation (Sekiguchi, Bebenroth, & Li, 2011), the nationality of the CEO was also controlled. Nationality was assumed based on the CEO's name. Koreans were designated 1 and foreigners were 0 as dummy variables. Based on the findings of Orser, Hogarth-Scott & Riding's (2000) study, in which firm size influenced business processes and financial outcomes, firm size was controlled. It was measured by the number of employees (Yoon, Diane, & Song, 2015). Because firm age can also affect a firm's performance (Stinchcombe & March, 1965), it was added to the control variables. Given that performance can vary according to an industry or organization (Miles, Snow, & Sharfman, 1993), the subsidiaries' industries were also controlled. The variable

industry was designated 1 as a dummy when the primary industry of a company was manufacturing, and otherwise coded as 0. Finally, the previous year's return on equity (ROE) was included in our model as a proxy for previous performance.

### 3. The Statistical Results

Prior to conducting a hypothesis test using regression analysis, a correlation analysis was performed between the variables used in this study. The results of the correlation analysis are shown in Table 1.

TABLE 1. Summary Statistics and Correlations

	M	S.D.	1	2	3	4	5	6	7	8
1. ROA	0.0510	0.09157	1.0000							
2. Cultural distance	3.0922	0.8930	0.0968*	1.0000						
3. Joint Venture	0.4703	0.4996	0.0514	-0.0774	1.0000					
4. Korean CEO	0.8030	0.3982	-0.0327	-0.0199	0.1253*	1.0000				
5. Firm Size	275.3114	838.9250	-0.0466	0.0625	0.0535	-0.0683	1.0000			
6. Subsidiary age	18.05297	9.9789	0.0805	-0.0074	0.2458*	0.0635	0.0185	1.0000		
7. Industry	0.4746	0.4999	0.0216	-0.0968*	-0.0370	0.0228	-0.0481	0.0103	1.0000	
8. Previous ROE	0.0792	0.5837	0.2288*	0.0275	0.0386	-0.0551	-0.0027	-0.0062	0.0234	1.0000

Note: \* $p < .05$

Because the highest value of the variance inflation factors (VIF) was below ten points, there were no problems of multicollinearity, and all of the variables could therefore be included in the regression model. Table 2 shows the results of the regression analysis. In Model 1, only the control variables were included; in Model 2, an independent variable was added.

TABLE 2. Statistical Findings from Regression Analysis

	model 1	model 2
Joint Venture	0.0057 [0.0086]	0.0073 [0.0086]
Korean CEO	-0.0076 [0.0007]	-0.0075 [0.0104]
Firm Size	-0.0000 [0.0000]	-0.0000 [0.0001]
Subsidiary age	0.0007* [0.0004]	0.0007* [0.0004]



TABLE 2 continued

	model 1	model 2
Industry	0.0028 [0.0082]	0.0045 [0.0082]
Previous ROE	0.0354*** [0.0071]	0.0349*** [0.0070]
Cultural distance		0.0102** [0.0046]
_cons	0.0390*** [0.0124]	0.0062* [0.0193]
N	472	472
R-sq	0.0632	0.0729
adj. R-sq	0.0511	0.0589
F	5.23***	5.21***

Note: \* $p < .10$ , \*\* $p < .05$ , \*\*\* $p < .01$

F-statistics suggest that all of our regression models were statistically significant. Based on the regression analysis, the hypothesis was accepted. The coefficient of the independent variable appears to be statistically significant with a positive sign. Specifically, increased cultural distance between an investor country and Korea showed a positive relationship with the results of the performance of foreign capital investment companies. Regarding the control variables, subsidiary age and previous ROE both showed statistically significant results with positive signs in Models 1 and 2. These results suggest that experience in a host country tends to facilitate a subsidiary's performance, and that previous performance is also an important predictor of a subsidiary's performance.

#### 4. Conclusions and Discussion

In this study, an empirical analysis was conducted on the effects of cultural distance between investor countries and Korea on corporate performance. Four hundred and seventy-two foreign invested companies doing business in Korea were targeted. To measure the difference between the countries' cultures, Kogut & Singh's (1988) cultural distance (often used in the international business arena) was used as a barometer. The empirical analysis confirmed that there was a positive relationship between the performance of foreign subsidiaries entering Korea and their cultural distance from Korea. There are several reasons for this result.

First, the disadvantages of cultural distance are becoming weaker. With the globalization of the market and increasing mergers and acquisitions (M&As) across borders, it can be seen that the problems commonly identified as disadvantages are being significantly resolved. Due to FDI in Korea over several decades, the indirect learning related to systematic and language differences and Korea's unique characteristics may have been implemented. As Evans & Mavondo (2002) observe, companies entering

countries with different cultural characteristics may engage in additional research and preparation and undertake additional trials and initiatives to offset the disadvantages of cultural distance.

Second, cultural distance can create knowledge, and consequentially organizational learning. Firms entering countries with cultural and psychological differences may have difficulty implementing the same business activities and knowledge they previously relied on. Therefore, it can be inferred that organizations facing entirely new and different cultures have many learning opportunities (Chung & Yoon, 2015). As the organizations obtain new, external knowledge, they are expanding their knowledge base (Huber, 1991; Yoon & Han, 2017). It can be argued that the activities and innovations needed to adapt to different cultures stimulate organizational learning, and ultimately positively impact a company's performance.

This study confirms that cultural distance, which has shown contradictory results on FDI outcomes so far, is a factor that directly affects the financial performance of foreign subsidiaries. It makes an important contribution to the literature on international business by shedding light on cultural distance, a well-established but somewhat neglected concept in the international business arena. Unlike most previous studies in which cultural distance is used as a control or moderating variable, in this study it is used as an independent variable in the context of globalization through foreign direct investments in Korea. We believe that such results can provide practical implications not only for foreign companies considering FDI in Korea but also for Korean firms preparing for FDI in global markets. For example, the management initiatives of foreign subsidiaries in Korea need to be strengthened to capture learning opportunities in Korea, which may stem from long distance cultural differences. Learning action is more effective when subsidiaries have greater autonomy.

In this study, there are several limitations to be addressed in future studies. First, the foreign investors who became the subjects of investment were not controlled. For instance, in the case of cross-border acquisition performance, even though the previous experiences of the acquirer can have an influence (Dikova & Sahib, 2013), this study failed to control the previous experiences with FDI of the parent companies of foreign subsidiaries selected as samples. Second, the key paper relied on for this research was Hofstede's "Cultural dimensions in management and planning (1984b)." Considering the context of the paper, focusing on the Asia Pacific region, we believed the four dimensions would be important enough to contribute to a cultural distance related empirical study in Korea. In the future, other scholars can extend this research by including the other two remaining dimensions. Third, the effects of investment size and the influence of the parent companies were not controlled. When entering foreign markets, some firms try to align their subsidiaries with the headquarters' strategic directions, whereas others actively use a localization strategy. If such aspects are addressed in future research, more sophisticated conclusions could be drawn.

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