The effect of performance evaluation schemes on predicted transfer prices: Do leadership tone and perceived fairness concerns matter?

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ABSTRACT

This paper experimentally investigates two control mechanisms that firms can use to avoid negotiation conflicts in negotiated transfer pricing decisions: leadership tone and performance evaluation schemes. When division managers are evaluated using a competitive performance evaluation scheme, a supportive leadership tone leads to a higher likelihood that divisions will settle on a transfer price close to the equal-profit transfer price. In contrast, when division managers are evaluated using a cooperative performance evaluation scheme, leadership tone does not significantly affect the likelihood that divisions settle on an equal-profit transfer price. These results demonstrate that firms, maintaining individual performance evaluations in a decentralized company structure, can use an informal control such as leadership tone to manage negotiation conflicts.

1. Introduction

Vertically integrated firms use transfer pricing negotiations to manage information asymmetry between independent divisions. A potential disadvantage of negotiating transfer prices is that negotiation breakdowns can lead divisions to trade with outside firms, against the best interests of the integrated firm. Senior management might prefer that divisions trade internally at a different price from the market price to place price pressure on external suppliers (Arya and Mittendorf, 2010) or to allow the upstream division to enter new markets (Cools and Slagmulder, 2009). An equitable distribution of gains is an important condition for the successful continuation of a relationship (Dekker, 2004). In this paper, we follow prior experimental research and operationalize an equitable distribution as an equal-profit split in our experiment (Chang et al., 2008; Kachelmeier and Towry, 2002; Luft and Libby, 1997). We investigate how headquarters can motivate divisions to agree on a transfer price close to the equal-profit split and away from the market price (and an unequal-profit split).

Senior management can incentivize divisions to consider the effect of their behavior on other divisions (e.g., Abernethy et al., 2004; Bouwens and Van Lent, 2007). However, joint profit incentives are noisier and less controllable by the division than are divisional profit incentives, which renders joint incentives less attractive for division managers (Bouwens and Van Lent, 2007; Hölmstrom, 1979). Moreover, performance evaluations based on the profit of other divisions can run against the idea of decentralization, where entrepreneurial managers operate independent units. Ghosh (2000a) showed that, with joint profit incentives, transfer price negotiators are less motivated to search for integrative solutions and free ride on the effort of their negotiation partner.

Thus, we investigate leadership tone as an alternative, low-cost management tool. Leadership tone is defined in this study as the extent to which the top of the organization supports the development of social relationships between employees. Leadership style has been found to have a direct effect on a firm’s strategic priorities and implementation of formal control systems (e.g., Abernethy et al., 2010; Nguyen et al., 2017). To date, despite the empirical evidence to suggest that performance evaluation schemes (Ghosh, 2000a,b; Ghosh and Bodt, 2006; Greenberg et al., 1994; Ravenscroft et al., 1993) can affect managers’ transfer pricing judgments, it is unknown precisely how the type of performance evaluation scheme influences managers’ predicted transfer pricing decisions in the presence of different leadership tones. Leadership tone can evoke concern-for-others and motivate divisions to accept a transfer price closer to an equal-profit transfer price.

Prior studies have demonstrated that managers’ transfer pricing decisions are affected by fairness concerns (Kachelmeier and Towry, 2002; Luft and Libby, 1997). Fairness concerns refer to the expectation of transfer prices formed by managers, where incentives for wealth maximization tend to override fairness expectations in equilibrium-price predictions (Kachelmeier and Towry, 2002). Prior studies have
demonstrated that managers’ perceived fairness concern is an important social factor in negotiations (Levicki et al., 2006; Masschelein et al., 2012). Thus, our research question is as follows: do leadership tone and performance evaluation schemes affect managers’ perceived fairness concerns and managers’ predicted transfer prices? We hypothesize that a more supportive leadership tone increases the likelihood that managers of divisions will predict a transfer price outcome closer to an equal-profit price, particularly when these managers are working under a competitive performance evaluation scheme. We further hypothesize that these effects are mediated by fairness concerns.

We ran an experiment where participants adopted the role of either a buying or selling division. The participants read a transfer pricing scenario adapted from Chang et al. (2008), and were asked to predict the expected transfer price. Given that the outside-market price is higher than the equal-profit price, the selling participants had an advantage over the buying divisions. We found that selling divisions are more likely to compromise with their negotiating counterparts to the extent of predicting a price lower than the market price, and closer to the equal-profit price, when the leadership tone is more supportive under a competitive performance evaluation scheme. Buying divisions did not exhibit this interaction effect, and predicted lower transfer prices with a more supportive leadership tone independent of the type of performance evaluation scheme (competitive or cooperative). An explanation for the difference between buying and selling divisions is that the buying divisions failed to consider the effect of the cooperative performance evaluation scheme on the selling divisions. Surprisingly, further analysis showed that the effects of the performance evaluation and leadership tone were not mediated by the participants’ fairness concerns.

Our main contribution is that we show that firms can manage transfer pricing negotiation conflicts with a supportive leadership tone in the presence of a competitive performance evaluation scheme. This finding indicates that firms with a supportive leadership tone can reap the benefits of decentralization and a competitive performance evaluation scheme, such as improved decision making and increased effort, while minimizing the cost of interdivisional conflicts.

The remainder of this paper is organized as follows. Section 2 develops the hypotheses of this study. Section 3 describes the research method and statistical techniques used to test the hypotheses, while Section 4 discusses the results of the study. Finally, Section 5 presents the conclusions and discusses the limitations of the research.

2. Theoretical development and hypotheses

2.1. Social exchange and transfer pricing

Behavioral literature suggests that people are social creatures and have a social need to feel part of a group. Research in social psychology (e.g., Leary et al., 1994; Tice et al., 1995) argues that organizations have norms of acceptable behaviors, and that people learn to conform to those norms to be viewed favorably by others. Therefore, social concerns affect judgments and behavioral outcomes in organizations. For example, Mas and Moretti (2009) found that workers are not only motivated by social considerations, but are also willing to relinquish monetary benefits to conform to the social environment.

This suggests that, besides performance evaluation, social concerns can shape managers’ negotiation behaviors, and it highlights the importance of social controls in shaping managers’ behavior. Social exchange theory suggests that individuals weigh the potential costs and benefits of social relationships. Continuation of these social relationships is based on a process of negotiated exchange between parties (Sabatelli and Shehan, 1993), in which the parties decide whether to continue or discontinue the social reciprocity and sustenance of the relationship, which translates to the decision to trade internally and not go with the market price in a transfer pricing setting. Similarly, Dekker (2004) described relational trust as an expectation that individuals will perform in the best interests of the relationship, even if it is not in their personal interest to do so. This implies an element of reducing self-interest for the benefit of the relationship, and illustrates the preference for relationship preservation in social interaction.

The importance of social concerns has been highlighted in prior transfer pricing research (e.g., Chang et al., 2008; Kachelmeier and Towry, 2002; Luft and Libby, 1997). In particular, Chang et al. (2008) found that managers negotiate lower transfer prices when they are negotiating with a partner with a high level of concern-for-others, as opposed to when they are negotiating with a partner with a low level of concern-for-others. Chang et al. (2008, pp. 706–707) argued that “this is because managers tend to reciprocate the perceived social concerns of their negotiation partner.” Thus, managers behave in a socially desirable manner to conform to the social norm of the environment to sustain long-term and trusting interpersonal relationships. This means that senior management can manage divisions by shaping the work environment to stimulate concern-for-others. Our study differs from prior literature in that it investigates how performance evaluation schemes and leadership tone can stimulate such concern-for-others.

2.2. Effect of leadership tone on predicted transfer prices

Prior studies have demonstrated that there is a strong link between leadership and the work environment (e.g., Bashshur et al., 2011; Dragoni and Kuenzi, 2012; Eisenbeiss et al., 2008; Kozlowski and Doherty, 1989). For example, Kozlowski and Doherty (1989) found that leadership is a major driver of the organizational climate. This suggests that employees’ behaviors can be influenced and motivated by senior management (leaders) of organizations because such leaders set the tone for the organization’s internal environment. Indeed, prior studies (e.g., Chong and Ferdiansah, 2011; Chong and Loy, 2015; Cianci and Kaplan, 2010; Francis et al., 2008; Rogers and Stocken, 2005) have suggested that a leader’s reputation influences employees’ intentions and behavior.

In the context of a negotiated transfer pricing decision, a leadership tone supportive of a collaborative work climate motivates divisions to focus on the outcomes of both divisions. For example, Chang et al. (2008) demonstrated that, when divisions show a greater concern-for-others, they are more likely to reach an agreement closer to the equal-profit outcome under a collaborative leadership tone that endorses a workplace climate that promotes a collaborative work environment. Thus, we test the following hypothesis:

H1. Predicted transfer prices are closer to an equal-profit price under a supportive leadership tone than they are under a non-supportive leadership tone.

2.3. Effect of performance evaluation schemes and leadership tone on predicted transfer prices

Previous research (e.g., Ackelsberg and Yuki, 1979; Anctil and Dutta, 1999; Ghosh, 2000a,b; Ghosh and Boldt, 2006; Ravenscroft and Haka, 1996) has suggested that using performance evaluation and compensation schemes can influence managers’ transfer pricing decisions. Our study distinguishes between a cooperative performance evaluation scheme and a competitive performance evaluation scheme. Under a cooperative performance evaluation scheme, divisions are evaluated based on firm-wide profits. Under a competitive performance evaluation scheme, divisions are evaluated based on divisional profits (Anctil and Dutta, 1999). Prior studies have found that, under a cooperative performance evaluation scheme, employees are encouraged to cooperate with others because their incentive payment is based at least partially on the performance of their co-workers (Nalebuff and...
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