Influences of Culture on Transfer Price Negotiation☆

Mohamed E. Husseina, Michael Kratena, Michael Kratena, Michael Kratena, Michael Kratena

a Accounting Department, School of Business, University of Connecticut, 2100 Hillside Road, Unit 1041, Storrs, CT 06269-1041, United States
b Department of Accountancy, School of Business, Providence College, 1 Cunningham Square, Providence, RI 02918-7001, United States
c Milgard School of Business, University of Washington Tacoma, 1900 Commerce Street, Tacoma, WA 98402-3100, United States
d Department of Accounting and Law, School of Business, University at Albany, 1400 Washington Ave., Albany, NY 12222, United States

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ABSTRACT

Luft and Libby (1997) posit that American transfer price negotiators tend to settle on prices that result in smaller differences in profit between divisions than the external market price will dictate. They attribute the results to a fairness effect. While fairness is present in all cultures, what is considered “fair” differs between cultures (Bian & Keller, 1999; Bolton et al., 2009; Gao, 2009; Surowiecki, 2009). This study ascertains whether cultural affiliation of the negotiator impacts this fairness effect. American and Chinese subjects participated in within-culture and cross-cultural negotiations in an experiment modeled after Luft and Libby (1997). Our results confirm Luft and Libby’s (1997) fairness effect when American participants negotiate with each other, but illustrate a contrary effect when Chinese participants negotiate with each other. The negotiator’s cultural affiliation is found to determine profit distribution in cross-cultural negotiations. These findings are consistent with longstanding theories of cultural traits (Hofstede, 1980) that are relevant to transfer price negotiation activities. Our results imply that the fairness effect in transfer price negotiation may need to be refined to account for the impact of culture.

1. Introduction

Transfer pricing, as an accounting research topic, has been the focus of numerous experimental studies for many decades (Kachelmeier & Towry, 2002; Luft & Libby, 1997). The fairness effect in transfer price negotiation posits that negotiators tend to seek smaller spreads in profit between divisional parties than the parties would otherwise achieve by simply adopting the external market price as the transfer price. In other words, negotiators exhibit a bias towards relatively “fair” and equal profit sharing, particularly when extreme market prices would result in a relatively unequal (and thus, in the perceptions of the negotiators, “unfair”) division of profits. However, research on cultural effects suggest that transfer price negotiation studies, originally conducted with American participants, could yield different outcomes when the participant's cultural background changes (Adair, Brett, & Okumura, 2001; Cravens, 1997; Gelfand et al., 2002).

This study examines how the “fairness effect” documented by Luft and Libby (1997) and Kachelmeier and Towry (2002) differs between Americans and Chinese.1 The choice of these two cultures is based on two considerations: (1) the extensive cross-border
transactions between the U.S. and China, and (2) significant differences in power distance and the levels of individualism/collectivism between the two cultures. This cross-cultural manipulation is relevant in both a theoretical and an empirical sense, not only because the transfer pricing mechanism is an omnipresent fixture of global firms, but also because transfer prices negotiated by divisional managers in different nations may be influenced by their cultural differences.

This topic is a timely one, considering that many international firms are moving large portions of their component manufacturing, sales support, and administrative processes to other countries. Li and Ferreira (2008), for instance, reported that intra-firm trade represented 55% of the trade between the EU and Japan, 40% of the trade between the EU and the U.S., and 80% of the trade between Japan and the U.S. as early as 1993. Urquidi (2008) reported that intra-firm cross border trade in services increased from $26.9 billion in 1997 to $57.6 billion in 2006.

Our theoretical predictions are based on longstanding theories on cultural traits (Hofstede, 1980) relevant to cross-cultural negotiations. In particular, Hofstede's power distance was deemed the most important explanatory dimension of differences in reward allocation (Fischer & Smith, 2003). Hofstede (2001) and Hofstede, Hofstede, and Minkov (2010) predict that a large power distance culture (e.g., Chinese) accepts inequalities between people more readily than a small power distance culture (e.g., American). We therefore expect American and Chinese cultural traits to engender different extent of profit sharing in transfer price negotiations.

We adopted a slightly modified version of the case first employed by Luft and Libby (1997), and later by Kachelmeier and Towry (2002) in which American and Chinese students in a Master of Science in Accounting (MSA) program negotiated for transfer prices through emails. We found that American respondents agreed to transfer prices that resulted in significantly more equitable profit distributions than those agreed to by Chinese respondents. Intra-cultural negotiations produced significantly higher percentages of transfer price agreements than inter-cultural negotiations. Significantly larger profit spreads between negotiators are reached by the empowered Chinese negotiator than the empowered American negotiator. These observations support the notion that the concept of fairness varies across cultures, and that cultural differences impact transfer price negotiations.

Our results imply that the fairness effect defined in previous transfer pricing negotiation studies may need to be refined to account for the impact of culture. Although the culture variable is relevant to many research topics, it is particularly important to the study of transfer pricing in an era when global companies are increasingly placing supplier and purchaser divisions in different regions of the world.

Our findings have significant ramifications for organizations that rely heavily on cross-cultural divisions and global networking strategies. Transnational companies must account for the impact of national cultures on negotiated transfer prices and other transactional terms. It is advisable that companies should emphasize cultural awareness in training divisional managers, and modify their negotiation processes to reflect such cultural differences. Perhaps most importantly, by integrating theories from cultural studies into transfer pricing research, our study broadens the theoretical base and strengthens the practical relevance of managerial accounting literature.

This study contributes to two streams of literature. First, it adds to the literature on how cultural traits influence transfer price negotiations. Chan (1998) examines the impact of the long-term orientation dimension of Australian vs. U.S. negotiators on transfer pricing negotiation outcomes. Our study enriches this literature stream by focusing on the impact of the power distance dimension on transfer price negotiation. Second, this study also adds to the broader stream of literature on how culture influences managerial decisions. Prior studies examine the influence of culture on managerial decisions in various contexts such as management control preference, private information communication, and informal information sharing (Chow, Harrison, McKinnon, & Wu, 1999; Chow, Hwang, Liao, & Wu, 1998; Chow, Kato, & Shields, 1994). Our study adds the transfer price negotiation context to this literature stream.

Section 2 reviews the literature relevant to this study. Section 3 develops experimental hypotheses. Section 4 then describes the research method. Research results are discussed in Section 5. Finally, Section 6 concludes, suggests future research opportunities, and acknowledges limitations.

2. Literature review

2.1. Transfer pricing and fairness

Transfer pricing serves to allocate profits between divisions in a manner that aligns the interests of the division managers with the interests of the firm and its shareholders (Williamson, 1975). To achieve this goal, many organizations grant division managers a significant degree of autonomy to negotiate transfer prices and make other operating decisions (Schuster & Clarke, 2010). Luft and Libby (1997), citing surveys conducted by Price Waterhouse (1984) and Eccles (1985), report widespread use of negotiation techniques to establish transfer prices.

One stream of transfer pricing research (Chalos & Haka, 1990; Ghosh, 1994; Kachelmeier & Towry, 2002; Kraten, 2007a; Luft & Libby, 1997) addresses the concept of fairness in economic decisions, and draws on studies of fairness in various human interactions, especially those concerning resource allocations (Bolton et al., 2009; Buchan, Croson, & Johnson, 2004; Gao, 2009; Kahneman, Knetsch, & Thaler, 1986). Although conventional economic theory presumes that decision makers are primarily motivated by self-interest (Luft & Libby, 1997), negotiators caring about fairness may prefer outcomes that allocate resources more equally under certain circumstances. People may choose not to maximize their own well-being out of concerns for others and adherence to standards of fairness (Gao, 2009; Kachelmeier & Towry, 2002; Kahneman et al., 1986; Luft & Libby, 1997).

When transfer prices are negotiated, divisional managers may not necessarily perceive the negotiation process and/or its resultant allocation of profits to be “fair” to all stakeholders. Luft and Libby (1997) noted that, even when an external market price is known,
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