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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

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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,

the negotiated transfer price may differ from the market price when the adoption of the market price as a transfer price would result in a highly unequal distribution of profits between the negotiating divisions. Furthermore, in an experiment with experienced managers, [Luft and Libby \(1997\)](#) found that product cost and accounting profit information influence the transfer price expected by divisional managers. They report that some managers expect transfer prices to reflect a modest sacrifice of profits by one division in order to reduce interdivisional profit inequities.

This particular fairness effect, as well as other behavioral traits of fairness, has been noted in the economics literature as well as the accounting literature. Fairness considerations influence the initial expectations of negotiators, even though wealth maximization incentives ultimately overpower those considerations ([Franciosi, Kujal, Michelitsch, Smith, & Deng, 1995](#)). Complementary arrangements during transfer price negotiations significantly increased perceptions of fairness ([Ghosh, 2000](#)). Moreover, [Kachelmeier and Towry's \(2002\)](#) transfer price study explicitly exploited "... the comparative advantage of the accounting literature in integrating both economic and psychological insights."

Using a modified version of the [Luft and Libby \(1997\)](#) case, [Kachelmeier and Towry \(2002\)](#) conducted both face-to-face and computerized experiments on negotiated transfer prices. Although they did not find significant differences in expected transfer prices between the face-to-face and computerized negotiation formats, they did find that actual negotiated transfer prices in the face-to-face format were significantly "fairer" (i.e., a more equitable distribution of profits between divisions) than the market price. Because computerized negotiations did not produce fairer outcomes than the market price, [Kachelmeier and Towry \(2002\)](#) concluded that the lack of social presence ([Bazerman, Curhan, Moore, & Valley, 2000](#)) in the computerized format served to "dehumanize" the negotiation process, thereby neutralizing the fairness effect.

All of the above studies, however, were conducted with American participants in the United States, and did not address cultural differences. Although the concept of fairness exists in all cultures, what is considered "fair" differs between cultures ([Bian & Keller, 1999](#); [Bolton et al., 2009](#); [Gao, 2009](#); [Gelfand et al., 2002](#); [Surowiecki, 2009](#)). Cultural differences can significantly impact cross-country negotiations ([Adair et al., 2001](#); [Choy & Lee, 2009](#); [Hofstede, 1980](#); [Hofstede, 1991](#); [Hofstede, Jonker, & Verwaart, 2012](#); [Tata, 2005](#); [Tata, Fu, & Wu, 2003](#)).

2.2. Culture and reward allocation

[Hofstede's \(2001\)](#); [Hofstede, Hofstede, and Minkov, \(2010\)](#) cultural dimensions theory describes a six dimension framework along which cultural values could be analyzed. Individualism/collectivism and power distance are two of these six cultural dimensions extensively studied by [Hofstede \(1980, 1991, 1997, and 2001\)](#), [Hofstede and Bond \(1988\)](#), [Hofstede and Hofstede \(2005\)](#), and [Hofstede, Jonker, & Verwaart \(2012\)](#).

Asian cultures like Chinese are more collectivistic than North American cultures like American ([Triandis, 1989](#)). In collectivist cultures, needs and success are defined at the group level ([Kachelmeier & Shehata, 1997](#)). [Triandis \(1994, page 4\)](#) described collectivism as characterized by associative, intimate relations with in-groups and dissociative formal relations with out-groups. Collectivist cultures differentiate between in-group versus out-group members ([Volkema, 2004](#) and [Volkema, 2011](#); [Hofstede, Hofstede, and Minkov, 2010](#)). Members of collectivist cultures are highly dependent on in-groups and powerful parties, and will tend to expect and accept significantly unequal outcomes driven by power difference ([Hofstede, 1997](#)).

In individualist cultures like the U.S., needs and success are defined at the individual level ([Kachelmeier & Shehata, 1997](#)). Members of individualist cultures are relatively independent of in-groups and powerful parties, and will tend *not* to expect or accept significantly unequal outcomes driven by power difference ([Hofstede, 1997](#)).

In a meta-analysis of cross-cultural reward allocation by disinterested allocators, [Fischer and Smith \(2003\)](#) concluded that Hofstede's power distance was the most important explanatory dimension of differences in reward allocation. [Fischer and Smith's \(2003\)](#) observation highlights the need to look beyond individualism/collectivism.

According to [Hofstede \(2001\)](#) and [Hofstede, Hofstede, and Minkov \(2010\)](#), a culture with large power distance accepts and perpetuates inequalities between people. On the other hand, a culture with small power distance values equality and ignores differences in personal status. Unequal distributions of rewards and other resources in favor of the powerful are more likely to be perceived as unfair in cultures with smaller power distances ([Hofstede, 1997](#)). Hierarchical and large power distance cultures (e.g., Chinese culture) are expected to allocate rewards more differentially on the basis of equity and performance, while egalitarian and small power distance cultures (e.g., American culture) are expected to favor equality in allocating rewards ([Fischer & Smith, 2003](#)).

[Cravens \(1997\)](#) remarks that as a result of cultural differences, "it is extremely challenging to make decisions which apply uniformly in a variety of national markets." It is therefore unclear if [Luft and Libby's \(1997\)](#) and [Kachelmeier and Towry's \(2002\)](#) insights gained from American subjects are relevant beyond a small power distance and highly individualistic culture such as the U.S. culture.

3. Hypothesis development

Several studies outside of the transfer pricing literature utilizing American and Chinese respondents have reported differences in responses across cultures ([Earley, 1989](#); [Kachelmeier & Shehata, 1997](#); [Morris, Podolny, & Sullivan, 2008](#); [Tata et al., 2003](#)). According to [Hofstede \(1991\)](#), American culture is individualistic in nature and features a small power distance. Conversely, the Chinese culture is collectivist in nature and features a large power distance. [Hofstede and Hofstede \(2005\)](#) reported highly significant differences between American and Chinese cultures in the dimensions of individualism/collectivism and power distance. We expect American and Chinese negotiators to behave differently in reward allocation. When division managers from different cultures vary in

their conceptions of fairness, they may not easily agree on negotiated transfer prices that could be considered “fair” by all parties.

Intercultural negotiations suffer from multiple sources of conflict which include differences between cultures in framing of negotiation, in emotional experiences, in communication and strategies, and in the construction of the social context (Gelfand & Brett, 2004). In addition, behavioral differences across cultures are serious obstacles to reaching agreements (Leung & Tong, 2004). Cultural differences can induce negative emotions, increase the time required to reach an agreement, and lead to a suboptimal agreement or even complete breakdown of negotiations (Kumar, 2004).

Collectivists regard groups with different cultural background as markedly out-groups (Hofstede & Hofstede, 2005). Cross-cultural interactions strengthen the identity of each cultural group rather than enhance mutual understanding (Hofstede, 1997). Cross-cultural interaction with one party being collectivist and the other individualist is therefore not necessarily smooth. On the other hand, intra-cultural negotiations are smoother because shared fairness norms facilitate exchange and reduce the need for information processing (Grandori & Neri, 1999). We therefore expect cross-cultural negotiations between American and Chinese participants to be more protracted in nature, and result in fewer agreements, than intra-cultural negotiations. Thus, intra-cultural negotiations between two Chinese negotiators or two American negotiators are expected to produce more agreements than cross-cultural negotiations between American and Chinese negotiators.

H1a. : The percentage of negotiated transfer price agreements reached between two Chinese or between two Americans is greater than that between a Chinese and an American.

In individualist cultures such as the U.S., people focus on personal needs and success. The outcomes of negotiations between two Americans is not straightforward when negotiators have different personal expectations (Kachelmeier & Towry, 2002; Luft & Libby, 1997). Luft and Libby (1997) found that buyers had lower expected and reservation prices than the sellers. Similarly, Kachelmeier and Towry (2002) reported that sellers expected higher prices than buyers, and even in face-to-face negotiations where fairness pressure was highest, the average price reached did not distribute profit equally if the market favored the seller. These differences in expectations are expected to slow down transfer price negotiations.

On the other hand, because of the large power distance in the Chinese culture, the market price is acceptable as fair even when it results in significantly unequal distribution (Fischer & Smith, 2003; Hofstede & Hofstede, 2005). Less divergent expectations likely lead to more straightforward agreements between Chinese negotiators. Thus, reaching an agreement between two Chinese is expected to be quicker than between two Americans.

H1b. : Negotiated transfer price agreements are reached more quickly when Chinese negotiate with each other than when Americans negotiate with each other.

A large power distance culture such as Chinese defines a “fair” resource allocation differently from a small power distance culture such as American (Hofstede, 1997). Specifically, members of the Chinese culture will tend to regard unequal outcomes as fair if empowered members utilize their power to obtain the bulk of the resources, whereas members of the American culture will tend to regard unequal outcomes as unfair.

Thus, in transfer pricing negotiations where the external market price is significantly different from the equal-profit-price (i.e., the price dividing profits equally), Americans negotiating with Americans are expected to make final offers closer to the equal-profit-price than to the external market price. Conversely, Chinese negotiating with Chinese are expected to make final offers closer to the external market price than to the equal-profit-price. In other words, when the external market price significantly favors one party over another, dyads of Americans will nevertheless tend to agree on relatively equal distributions of profit as a fair outcome. However, dyads of Chinese will tend to accept the external market price as the “fair” transfer price, and agree on relatively unequal distributions of profit.²

H2a. : The profit spread between negotiators is larger when two Chinese negotiate than when two Americans negotiate.

In cross cultural transfer price negotiations, Chinese and American negotiators are expected to act in ways reflecting their respective cultures. Owing to the large power distance culture, a Chinese negotiator empowered by the market price will use his/her power to reach a transfer price close to the market price. On the other hand, an empowered American negotiator, because of a small power distance culture, will settle for a price lower than the market price.

Accordingly, we make the following prediction.

H2b. : The profit spread between cross-cultural negotiators is larger when the empowered party is a Chinese than when the empowered party is an American.

² Some may predict Chinese, as collectivists, to be more concerned about equality than the individualistic Americans, but this prediction is subject to challenges. First, the concern about equality applies only to in-group members rather than cross-cultural settings (Leung & Bond, 1984; Triandis, 1989), and is expected to succumb to wealth maximization incentives (Franciosi et al., 1995). Second, as just one of many interpretations of one of the dimensions of Hofstede's (2001) and Hofstede, Hofstede, and Minkov's (2010) model, the proneness to equality is unlikely to explain all cross-cultural differences. In fact, Kirkman, Lowe, and Gibson (2006) and Aslani et al. (2016) warn against disproportionate emphasis on individualism/collectivism in cross-cultural research. Research on individualist versus collectivist cultures as an explanation of how people allocate a reward has yielded mixed results (Gelfand, Erez, & Aycan, 2007). Fischer and Smith's (2003) remark that Hofstede's power distance was the most important explanatory dimension of differences in reward allocation highlights the need to look beyond individualism/collectivism.

4. Research method

We adapted the case instrument (see Appendix) originally developed by [Luft and Libby \(1997\)](#) and later modified by [Kachelmeier and Towry \(2002\)](#) and [Kraton \(2007b\)](#). The adapted case described a selling division with surplus labor. As the world transits to a knowledge economy driven by highly skilled labor, the surplus labor context is arguably more relevant than [Luft and Libby \(1997\)](#) product item context. For instance, the surplus labor context is meaningful to the accounting profession as it is common for Big Four accounting firms to obtain supplementary staff hours from their affiliates in other countries.

In our experiment, the selling division is allowed to sell surplus labor, costing \$20 per hour, to either a buying division for a negotiated transfer price, or to the external market. The market price is set at either \$30 to empower the buyer, or \$70 to empower the seller. The buying division is allowed to buy labor hours from either the selling division or the external market. It takes one unit of labor to produce each unit of product which will be sold to earn net profits of \$80 before labor cost. The seller's and the buyer's net profits are thus as follows:

$$\text{Buyer's net profit} = \$80 - \text{negotiated transfer price.} \quad (1)$$

$$\text{Seller's net profit} = \text{negotiated transfer price} - \$20. \quad (2)$$

The equal-profit-price is obtained by solving Eqs. (1) and (2). When the buyer's net profit equals the seller's net profit, the negotiated transfer price is \$50. Adding Eq. (1) to Eq. (2) gives the sum of the buyer's and the seller's net profits, which is \$60.

Negotiations continued for up to five rounds. If an agreement was not reached before or at the fifth round, each division was required to transact with the outside market and incur external contracting costs of \$3. Thus, all sellers in the \$70 market price games and all buyers in the \$30 market price games could guarantee themselves net profits of \$47 by avoiding agreements, while relegating their counterparts to net profits of \$7.

When no agreement is reached and the market price is \$70,
the seller's net profit = $70 - 20 - 3 = \$47$, and
the buyer's net profit = $80 - 70 - 3 = \$7$.

When no agreement is reached and the market price is \$30,
the seller's net profit = $30 - 20 - 3 = \$7$, and
the buyer's net profit = $80 - 30 - 3 = \$47$.

The corresponding profit spreads between negotiators at market prices of \$70 and \$30 are both $47 - 7 = \$40$, which are used in subsequent analyses when any negotiation results in no agreement. In a sensitivity analysis, excluding all cases where agreements are not reached did not materially change the results of this study.

To test our hypotheses, we recruited American and Chinese participants from a Master of Science in Accounting (MSA) program at a U.S. university. The facts that American and Chinese students went through the same screening in the admission process and were admitted by the same program provide some assurance that there is consistency in terms of knowledge and academic aptitude in the sample (see also the "Exploring Alternative Explanations" subsection in [Section 5](#)).

The MSA program was open to all applicants regardless of undergraduate major or professional experience, and did not target applicants with accounting background. It is therefore reasonable to assume that participants had learned accounting mainly from the MSA program, and had similar accounting background. Transfer pricing was formally taught as part of the MSA curriculum. The experiment was conducted after the professor had finished teaching transfer pricing in class.

Sixty-four American participants and 64 Chinese participants were divided into eight groups with dyad assignment and external market prices as follows:

Group	# of Dyads	Seller	Buyer	Market Price
1	8	Chinese	Chinese	70
2	8	Chinese	Chinese	30
3	8	American	American	70
4	8	American	American	30
5	8	American	Chinese	70
6	8	Chinese	American	30
7	8	Chinese	American	70
8	8	American	Chinese	30

Participants negotiated via email. [Bazerman et al.'s \(2000\)](#) "social presence continuum" represents the varying extent to which the setting (i.e., format) of negotiation exerts social pressure on the negotiators. [Kachelmeier and Towry \(2002\)](#) investigated the impact of the two extreme settings in [Bazerman et al.'s \(2000\)](#) social presence continuum on transfer price negotiation. These two extreme settings are (1) highly restricted negotiation through a specialized computer program, and (2) completely unrestricted face-to-face negotiation. Since social presence was not the focus of our study, we did not adopt these extreme settings. Instead, we opted for negotiation through emails because email and other text-based electronic communication systems have become a preferred mode of communication, especially at the global level ([Moore, Kurtzberg, Thompson, & Morris, 1999](#)). Email lies between the above two extremes, allowing rich communication while avoiding the humanization of face-to-face contact ([Kachelmeier & Towry, 2002](#)). The

Table 1
Descriptive statistics.

			(A)	(B)	(C)	(D)
Seller	Buyer	Market price	Number (percent) of agreements reached	Mean (S.D.) of rounds to reach agreement	Mean transfer price (S.D.) of cases with agreements	Mean profit spreads (S.D.) of all cases
Chinese	Chinese	\$70	8 of 8 (100%)	2.125 (0.835)	\$70.25 (0.463)	\$40.5 (0.926)
Chinese	Chinese	\$30	8 of 8 (100%)	2.000 (0.926)	\$30.13 (0.354)	40.25 (0.707)
<u>Mean rounds of Chinese/Chinese dyads</u>				<u>2.06</u>		
American	American	\$70	8 of 8 (100%)	4.875 (0.354)	\$52.88 (1.246)	5.75 (2.493)
American	American	\$30	7 of 8 (87.50%)	5.000 (0.000)	\$47.43 (1.397)	9.5 (12.593)
<u>Mean rounds of American/American dyads</u>				<u>4.94</u>		
<u>American-empowered dyads</u>						
American	Chinese	\$70	4 of 8 (50%)	5.000 (0.000)	\$57.00 (2.450)	26.25 (15.059)
Chinese	American	\$30	5 of 8 (62.50%)	4.800 (0.447)	\$40.80 (5.541)	26.5 (13.969)
<u>Chinese-empowered dyads</u>						
Chinese	American	\$70	3 of 8 (37.50%)	3.667 (1.528)	\$67.00 (2.000)	37.75 (3.770)
American	Chinese	\$30	4 of 8 (50%)	3.000 (0.817)	\$33.75 (1.500)	36.25 (4.464)

parallel-processing feature of electronic media, moreover, prevents any one individual from suppressing the views of others by dominating the discussion (Nunamaker, Dennis, Valancich, & Vogel, 1991).

Unlike Luft and Libby (1997) and Kachelmeier and Towry (2002), we offered participants financial rewards equivalent to their earned profits to better simulate the real world situation. When they reached agreements, participants divided the total reward of \$60 on the basis of the profits that they would have earned in accordance with their agreed-upon transfer prices. Conversely, when they didn't reach agreements, the parties empowered by the market price received \$47 and the un-empowered parties received \$7. Hence, the participants were aware that the outcomes of their negotiation activities would impact their actual financial rewards.

5. Results

Tests of Hypothesis H1a. : The percentage of negotiated transfer price agreements reached between two Chinese or between two Americans is greater than that between a Chinese and an American.

Table 1 presents descriptive statistics of the eight experimental groups. According to Column A, 100% (i.e., 16 out of 16) of the Chinese/Chinese dyads reached agreements and transacted with each other, and approximately 94% (i.e., 15 out of 16 dyads) of American/American dyads reached agreements and transacted with each other. However, only 50% of the cross-cultural dyads (i.e., 16 out of 32 dyads) achieved agreements and avoided the external contracting cost. Consistent with H1a, a *chi*-squared test (Table 2 Panel A) contrasting Chinese/Chinese and American/American dyads against Chinese/American and American/Chinese dyads establishes that the proportion of agreements reached within cultures is significantly greater than that reached between cultures (*chi*-squared 18.02; *p*-value = 0.000).

Tests of Hypothesis H1b. : Negotiated transfer price agreements are reached more quickly when Chinese negotiate with each other than when Americans negotiate with each other.

As reported in Column B of Table 1, the Chinese/Chinese dyads on average reached agreements in 2.125 (2.00) rounds when the market price was \$70 (\$30), which was quicker than the 4.875 (5.00) rounds of the American/American dyads. Consistent with H1b, Tukey's range test contrasting Chinese/Chinese dyads versus American/American dyads establishes significantly fewer rounds to agreement taken by Chinese than American negotiators (Table 2 Panel B Row 3, *diff* = - 2.871, *p*-value = 0.000).

Tests of Hypothesis H2a. : The profit spread between negotiators is larger when two Chinese negotiate than when two Americans negotiate.

As reported in Column C of Table 1, American/American dyads' mean transfer price of \$52.88 (\$47.43) at external market price of \$70 (\$30) was far closer to the equal-profit-price of \$50 than the Chinese/Chinese dyads' mean transfer price of \$70.25 (\$30.13). Column D of Table 1 presents the profit spreads between negotiators. The American/American dyads' mean profit spread of \$5.75 (\$9.50) at external market prices of \$70 (\$30) was smaller than the Chinese/Chinese dyads' mean profit spread of \$40.50 (\$40.25). Consistent with H2a, Tukey's range test contrasting Chinese/Chinese dyads versus American/American dyads establishes significantly larger profit spreads reached by Chinese than American negotiators (Table 2 Panel C Row 3, *diff* = 32.750, *p*-value = 0.000).

Table 2
Tests of Differences between Dyads.

Panel A		
Comparing proportion of agreement reached: intra vs. cross-cultural dyads		
Chi-sq		18.02
p-Value		0.000
Panel B		
Comparing rounds to agreement: Chinese dyads vs. American dyads		
Dyads	Diff in rounds	p-Value adj.
1 American-seller-Chinese-buyer vs. American-seller-American-buyer	- 0.933	0.064
2 Chinese-seller-American-buyer vs. American-seller-American-buyer	- 0.558	0.427
3 Chinese-seller-Chinese-buyer vs. American-seller-American-buyer	- 2.871	0.000
4 Chinese-seller-American-buyer vs. American-seller-Chinese-buyer	0.375	0.804
5 Chinese-seller-Chinese-buyer vs. American-seller-Chinese-buyer	- 1.939	0.000
6 Chinese-seller-Chinese-buyer vs. Chinese-seller-American-buyer	- 2.313	0.000
Panel C.		
Comparing Profit Spreads: Chinese Dyads vs. American Dyads.		
Dyads	Diff in spreads	p-Value adj.
1 American-seller-Chinese-buyer vs. American-seller-American-buyer	23.625	0.000
2 Chinese-seller-American-buyer vs. American-seller-American-buyer	24.500	0.000
3 Chinese-seller-Chinese-buyer vs. American-seller-American-buyer	32.750	0.000
4 Chinese-seller-American-buyer vs. American-seller-Chinese-buyer	0.875	0.994
5 Chinese-seller-Chinese-buyer vs. American-seller-Chinese-buyer	9.125	0.039
6 Chinese-seller-Chinese-buyer vs. Chinese-seller-American-buyer	8.250	0.074
Panel D		
Comparing profit spreads: Chinese-empowered vs. American-empowered cross-cultural dyads		
Dyads	Diff in spreads	p-Value adj.
1 Chinese-seller-Chinese-buyer vs. American-seller-American-buyer (<i>identical to Panel C Row 3</i>)	32.750	0.000
2 Inter-cultural (American empowered) vs. American-seller-American-buyer	18.750	0.000
3 Inter-cultural (Chinese empowered) vs. American-seller-American-buyer	29.375	0.000
4 Inter-cultural (American empowered) vs. Chinese-seller-Chinese-buyer	- 14.000	0.000
5 Inter-cultural (Chinese empowered) vs. Chinese-seller-Chinese-buyer	- 3.375	0.684
6 Inter-cultural (Chinese empowered) vs. Inter-cultural (American empowered)	10.625	0.005

Results relating directly to the hypotheses are in bold.

The ANOVA in [Table 3A](#) relates profit spread to market price and cultural affiliation of intra-cultural dyads. The interaction term *PRICE***CULTURE* is not significant, but the *CULTURE* indicator variable representing either American/American dyad or Chinese/Chinese dyad is highly significant ($F = 206.58$, p -value = 0.000), thus supporting H2a. These results support the notion that negotiators from a collectivist and large power distance culture accepted more unequal profit distributions than negotiators from an individualist and small power distance culture. Moreover, the evidence supporting H1b and H2a is consistent with the view that

Table 3A
ANOVA for Profit Spreads between negotiators: Chinese versus American intra-cultural dyads.

Source of Variation	SS	df	MS	F	p-Value
PRICE	24.5	1	24.5	0.59	0.449
CULTURE	8580.5	1	8580.5	206.58	0.000
PRICE*CULTURE	32	1	32	0.77	0.388
Within	1163	28	41.54		
Total	9800	31			

NOTE: This ANOVA table analyzes how profit spread is affected by market price and cultural affiliation of negotiating intra-cultural dyads. *PRICE* is an indicator variable related to the external market price, established at either \$30 or \$70. *CULTURE* is an indicator variable denoting either two American negotiators or two Chinese negotiators in intra-cultural dyads.

Table 3B
ANOVA for Profit Spreads between negotiators: Chinese-empowered versus American-empowered Cross-cultural Dyads.

Source of variation	SS	df	MS	F	p-value
PRICE	3.13	1	3.13	0.027	0.870
EMPOWER	903.13	1	903.12	7.921	0.009
PRICE*EMPOWER	6.13	1	6.13	0.054	0.818
Within	3192.50	28	114.02		
Total	4104.88	31			

NOTE: This ANOVA table analyzes how profit spread is affected by market price and the empowered culture of cross-cultural dyads. PRICE is an indicator variable related to external market price, established at either \$30 or \$70. EMPOWER is an indicator variable denoting either the American negotiator or the Chinese negotiator is empowered by the external market price.

American negotiators took additional time to negotiate away from the market price to more fairly distribute profits.

Tests of Hypothesis H2b. : The profit spread between cross-cultural negotiators is larger when the empowered party is a Chinese than when the empowered party is an American.

As reported in Column D of Table 1, empowered American sellers (buyers) in cross-cultural dyads agreed to a smaller profit spread of \$26.25 (\$26.50) than the profit spread of \$37.75 (\$36.25) achieved by empowered Chinese sellers (buyers). Tukey's range test (Table 2 Panel D Row 6, diff = 10.625; p -value = 0.005) attests to significantly larger profit spread when the Chinese negotiator is empowered than when the American negotiator is empowered in cross-cultural negotiations.

The ANOVA in Table 3B examines how profit spread is affected by market price and the empowered culture of cross-cultural dyads. The interaction term PRICE*EMPOWER is not significant, but the EMPOWER indicator variable representing either the American negotiator or the Chinese negotiator being empowered by the external market price is highly significant ($F = 7.921$, p -value = 0.009). These results support H2b, and are consistent with the view that empowered negotiators from a collectivist and large power distance culture seek higher profits than empowered negotiators from an individualist and small power distance culture.

5.1. Additional observations

Tukey's range test compares all possible pairings of groups and finds significant results in addition to those predicted by our hypotheses. These additional results, reported in Table 2 Panels B, C, and D, are consistent with Luft and Libby's (1997) fairness effect observed on American subjects and with the larger power distance in Chinese versus American culture.

In particular, in Table 2 Panel B Rows 5 and 6, Chinese-seller-Chinese-buyer dyads take significantly fewer rounds (diff = -1.939 and -2.313; p -value = 0.00) to reach agreement than inter-cultural dyads. These observations are consistent with the power distance explanation which predicts Chinese participants' readiness to accept the market price as fair. In Table 2 Panel C Rows 1 and 2, inter-cultural dyads achieve significantly (diff = 23.625 and 24.50; p -value = 0.00) larger profit spreads than American-seller-American-buyer dyads, which reflects Americans' inclination to allocate rewards more equally and confirms the fairness effect. In Table 2 Panel D, empowered Americans in inter-cultural dyads (Row 2) achieve significantly larger profit spread (diff = 18.75; p -value = 0.00) than American-seller-American-buyer dyads, reflecting un-empowered Chinese participants' acceptance of the market price as fair and American-seller-American-Buyer dyads' inclination to allocate rewards more equally. Empowered Chinese in inter-cultural dyads (Row 3), seeing the market price as fair, achieve significantly larger profit spread (diff = 29.375; p -value = 0.00) than American-seller-American-buyer dyads, who tend to allocate rewards more equally. Americans' inclination to allocate rewards more equally causes empowered Americans in inter-cultural dyads (Row 4) to achieve significantly smaller profit spread (diff = -14.00; p -value = 0.00) than Chinese-seller-Chinese-buyer dyads, who accept the market price as fair.

5.2. Exploring alternative explanations

The observed differences between American and Chinese students, admittedly, could be attributable to other factors such as accounting background, academic ability, and English proficiency.

It is reasonable to conjecture that Chinese students might be deficient in their accounting background and might have difficulty understanding the transfer price context, which caused them to anchor on the default settlement. To examine this conjecture, we tested for systematic differences in accounting scores between American and Chinese students in universities across the U.S. We collected data from a sample of 127 (78 Americans and 49 Chinese) graduate accounting students with non-accounting undergraduate degrees from five introductory management accounting course sections. To consider the five sections in aggregate, we conduct a MANOVA test with the final scores from the five sections as five dependent variables and the American/Chinese dummy as independent variable. The mean final score of American (Chinese) students is 81.5 (87.4), but the Wilks statistic and Pillai statistic are insignificant (both p -values = 0.058), suggesting that the independent variable does not significantly contribute to the model. If we include another 256 American students and 215 Chinese students taking other MS level accounting courses, the American and Chinese mean scores become 78.9 and 79.6, and the Wilks statistic and the Pillai statistic suggest that the independent variable significantly (both p -values = 0.000) contributes to the model. Since the Chinese mean scores are higher than the American mean scores in both samples, we do not find evidence that Chinese students in general have weaker accounting backgrounds relative to

their American counterparts.

The concern over differences in English proficiency is a fair comment since we have no basis to claim that Chinese students and American students have equal command of English. In response to this concern, we compared the Flesch, Fog, and Kincaid readability indexes of the case materials versus Chapter 1 of Kieso's Intermediate Accounting. As an introduction chapter, Kieso's Chapter 1 is far less technical and far more readable than the subsequent chapters. All three readability indexes consistently suggest that the case materials are easier to read than Chapter 1 of Kieso's Intermediate Accounting, and support our claim that the case was written in a clear language to avoid misunderstanding and confusion. To the extent that Chinese participants are expected to and are able to understand the first chapter of Kieso, they are likely to have no problem understanding our case materials.

6. Conclusions

The “fairness effect” of transfer price negotiation predicts that negotiators are biased towards “fair” and equal divisions of profits, particularly when market prices would result in grossly unequal profit distributions. Prior research (e.g., [Kachelmeier & Towry, 2002](#); [Luft & Libby, 1997](#)) based on American subjects supported the fairness effect. This experimental study extends the current literature by integrating [Hofstede's \(1994\)](#) cultural dimensions model with transfer price negotiation, and demonstrating how differently American and Chinese cultures affect such negotiations.

Perceptions of fairness are culture-specific. According to [Hofstede \(1997\)](#), collectivist cultures with a large power distance consider unequal profit distributions favoring empowered parties as fair. Conversely, individualist cultures with a small power distance consider such unequal distributions as unfair. Thus, in cross-cultural negotiations where these two cultures meet, differing perceptions of fairness may lead to more disagreements and longer time to reach agreement.

Using participants from the U.S. and China, we examine how differences in the concepts of fairness between cultures impact transfer price negotiation. Supporting [Luft and Libby \(1997\)](#) and [Kachelmeier and Towry \(2002\)](#), we note that Americans negotiating with other Americans tend to agree to transfer prices significantly different from the market price when the market price would result in highly unequal profits. On the other hand, evidence exists that cross-cultural differences in the perception of fairness affect transfer price negotiation. Chinese negotiating with other Chinese tend to settle close to the market price, which results in highly unequal profits. Furthermore, there are fewer agreements in cross-cultural dyads than in intra-culture dyads.

Future researchers may wish to explore the impact of social presence, previously investigated by [Kachelmeier and Towry \(2002\)](#), on negotiated transfer prices. [Kersten, Koeszegi, and Vetschera \(2003\)](#), for instance, posited that cultural dimensions such as power distance rely on communicating social cues. Thus, the significance of power distance might strengthen or weaken through the use of technologies that enhance or inhibit such communications.

In addition, future researchers may replicate and extend our study with cultures significantly different from American and Chinese in regards to the individualism/collectivism and power distance ([Hofstede, 1994](#)). Furthermore, they may explore whether self-reported perceptions of fairness and expectations of outcomes are consistent with actual negotiated profit distributions in experimental studies.

There are limitations in this study. First, this study relies on Hofstede's work in characterizing Chinese culture as collectivist with large power distance, and American culture as individualist with small power distance. To the extent that national cultures evolve over time, it is fair to doubt the validity of our characterization. Second, we have no evidence that participants' concerns over fairness are indeed the mechanism driving the observed results, which therefore could be open to alternative explanations. Third, we put the experiment in a surplus labor context because Big Four Accounting firms, among other service-based enterprises, are known to cross-utilize staff from offices across countries. We acknowledge that cross-utilization in other industries could be subject to industry-specific limitations.

Appendix A. Case instrument

Description of the case

The Global Corporation has two divisions:

BuyCorp, which needs to employ additional staff, is the buyer of surplus labor. BuyCorp can hire temporary workers from independent companies or from the SellCorp division.

SellCorp, which employs surplus workers who are no longer needed but who cannot be fired under government regulations, is the seller of surplus labor. SellCorp can sub-contract out these workers to independent companies or to the BuyCorp division.

The SellCorp and BuyCorp managers can transact with each other or with independent companies. However, it is more convenient (and a little cheaper) for SellCorp and BuyCorp to contract with each other for labor.

The hourly salary rate that BuyCorp pays SellCorp when they purchase their workers is negotiated by the two managers. Both managers can consider whatever factors seem appropriate when negotiating the rate.

However, if they can't agree on a rate, then BuyCorp will be forced to hire temporary employees from an independent company, and SellCorp will be forced to sub-contract their employees to other companies. This will be a little more costly because both managers will incur additional legal costs when they sign deals with other companies.

BuyCorp needs one hour of surplus employee time to complete each unit of product. SellCorp pays all of its workers \$20 per hour and BuyCorp's profit for each unit of product is \$80 less the salary paid for 1 h of employee time. Thus, once the two managers negotiate a rate, they will both know how much each will profit by their deal, as follows:

BuyCorp:

$$\$80 - \$ \text{ negotiated rate} = \text{net profit}$$

SellCorp:

$$\$ \text{ negotiated rate} - \$20 \text{ employee cost} = \text{net profit}$$

This table summarizes different levels of net profit for different negotiated rates:

Negotiated rate	\$20	\$30	\$35	\$40	\$45	\$50	\$55	\$60	\$65	\$70	\$80
BuyCorp profit	\$60	\$50	\$45	\$40	\$35	\$30	\$25	\$20	\$15	\$10	\$0
SellCorp profit	\$0	\$10	\$15	\$20	\$25	\$30	\$35	\$40	\$45	\$50	\$60

If the two managers cannot agree on a negotiated rate, then both of them will have to accept the “default” outside market rate as follows:

If the outside market rate is \$30, then SellCorp will earn \$10 of profit and BuyCorp will earn \$50 of profit. However, both parties will then need to pay \$3 in additional outside contracting costs, which will reduce their net profits to \$7 and \$47 respectively.

If the outside market rate is \$70, then SellCorp will earn \$50 of profit and BuyCorp will earn \$10 of profit. However, both parties will then need to pay \$3 in additional outside contracting costs, which will reduce their net profits to \$47 and \$7 respectively.

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