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Effect of ethical leadership and performance evaluation on transfer price prediction: A social learning experiment

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Abstract

Research aims: This paper investigates two control mechanisms that firms can use to avoid negotiation conflicts in negotiated transfer pricing decisions.

Design/Methodology/Approach: This experimental research used a 2x2 factorial design between subjects. This study involved 77 undergraduate economics and business students as participants.

Research findings: This result revealed that divisions evaluated with systems that value high ethical leadership and competitive performance evaluation schemes would set transfer prices close to equal profit transfer prices. These results suggest that companies with individual performance evaluations in a decentralized corporate structure can use informal controls such as ethical leadership to manage negotiation conflicts.

Theoretical contribution/ Originality: This study provides further knowledge to the ethical leadership literature by examining the influence of ethical leadership and performance evaluation schemes on transfer pricing. Previous research on leadership and transfer pricing prediction is limited and primarily focuses on tone leadership. This research, therefore, develops previous research by focusing on another leadership style, namely ethical leadership, with an experimental design.

Practitioner/Policy implication: This research provides an easy and low-cost alternative control mechanism to reduce conflicts that can occur in the transfer price negotiation process.

Research limitation/Implication: This research is limited to ethical leadership styles and limited transfer pricing mechanisms. Future research, thus, can use other leadership styles and other transfer pricing mechanisms, such as two-step pricing. Different mechanisms used can produce different decisions as well.

Keywords: Transfer Pricing; Performance Evaluation Schemes; Competitive; Cooperative; Social Learning Theory



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Introduction

A vertically integrated company consists of several decentralized divisions or business units. This means that each division has the authority to manage its own division, including setting transfer prices between divisions. Transfer price negotiations are used by divisions to manage information asymmetry between independent divisions (Chong et al., 2018; Lipp et al., 2023). However, transfer price negotiations do

not always reach an agreement. If the price cannot be agreed, divisions tend to transact with parties outside the company. This is against the best interest of the integrated company (Chong et al., 2018). Failure to negotiate the transfer price can lead to a split in the company. It takes the role of the board of directors as senior management to organize the relationships between divisions.

The board of directors provides incentives to encourage divisions in the company to think about how their actions affect other divisions (Abernethy et al., 2004; Bouwens & Van Lent, 2007). When divisions are incentivized by cooperative schemes or equal profit sharing, they are less interested because it means they have no control over the size of their incentives (Bouwens & Van Lent, 2007; Holmstrom, 1979). Nevertheless, if they are incentivized competitively (divisional profit), they tend to be more aggressive in pursuing the size of the bonus through transfer pricing (Ghosh, 2000a).

If the transfer price cannot be agreed upon, divisions tend to make transactions with parties outside the company to pursue greater profits. This is likely to create disputes between divisions. Meanwhile, senior management prefers divisions to transact within the firm to put pressure on external suppliers or give upstream divisions the opportunity to enter new markets (Arya & Mittendorf, 2010; Cools & Slagmulder, 2009). Thus, firms need simple management controls that can make divisions within the firm conduct intra-firm transactions and minimize disputes between divisions (Chong et al., 2018).

Leadership style has been found to have a direct effect on a company's strategic priorities and implementation of formal control systems (Abernethy et al., 2010; Nguyen et al., 2017), such as in managing internal conflict, enhancing transparency and trust, strengthening long-term performance, encouraging sustainable business practices, and mitigating compliance and regulatory risks (Avery & Bergsteiner, 2011; Treviño et al., 2000; Wong et al., 2020; Zhu et al., 2014). In managing internal conflict, ethical leadership plays a role in emphasizing ethical values. Leaders can encourage better cooperation and avoid disputes that harm company productivity and performance (Wong et al., 2020). Ethical leadership increases transparency in the pricing process and builds trust among the divisions involved. This trust is important to ensure that all parties feel fair and are motivated to achieve common goals, not only individual interests (Treviño et al., 2000; Wong et al., 2020). By applying ethical principles, companies can ensure that transfer pricing decisions support long-term performance, not only short-term profits (Avery & Bergsteiner, 2011). Ethical leadership helps maintain a balance between profitability and social responsibility, ultimately strengthening a company's reputation and sustainability. Ethical leadership in transfer price negotiations demonstrates a company's commitment to integrity and ethics, which can attract investors, customers, and business partners who value good business practices (Zhu et al., 2014). Therefore, the authors investigate ethical leadership as an alternative, low-cost management tool. The authors extend (Chong et al., 2018) by focusing on another leadership style, ethical leadership.

Ethical leadership is described as the identification of normatively suitable behaviors through personal acts and interpersonal interactions and the promotion of such behaviors to followers through two-way communication, reinforcement, and decision-making

(Brown et al., 2005). Despite empirical evidence indicating that performance evaluation schemes have a direct influence on corporate strategies (Abernethy et al., 2010; Chang et al., 2008; Chong et al., 2018; Fisher et al., 2002; Ghosh & Boldt, 2006; Klein & Speckbacher, 2019; Miloloža, 2018; Nguyen et al., 2017), it is unclear how the type ethical leadership can inspire divisions to accept transfer prices that are close to the transfer price of equal profits.

Prior research has focused on tone leadership in relation to transfer pricing prediction. For that reason, this study fills the gap by examining the impact of ethical leadership, which is a leadership style different from prior research. The authors differentiate ethical leadership into two levels, which are high and low, using an experimental design. By investigating how ethical leadership and performance evaluation schemes influence transfer pricing decisions, this study offers insights into an unexplored area, contributing to a deeper understanding of how organizational control can reduce negotiation conflict in transfer pricing decisions. The novelty of this study lies in its dual focus on ethical leadership and performance evaluation schemes, which have received relatively less attention in the context of transfer pricing. By adopting an experimental approach with a factorial design, this study provides empirical evidence regarding the interaction between these variables and their impact on transfer pricing outcomes. This fills a void in the literature and expands the understanding of the mechanisms that firms can use to manage negotiation conflicts in transfer pricing decisions.

Thus, this research's questions are as follows: Do ethical leadership and performance evaluation schemes motivate divisions to agree on transfer prices that are close to equal profit sharing, away from market prices and unequal profit sharing? The authors hypothesize that divisional managers operating under cooperative performance evaluation schemes are more likely to predict transfer price outcomes that are close to equal profit prices when ethical role models lead them. The authors ran an experiment with participants adopting sales division roles. Participants were asked to predict the expected transfer price after reading a transfer pricing scenario developed by Chong et al. (2018). Considering that the price outside the market is higher than the equalized profit price, the seller has an advantage over the buyer. The authors found that ethical leadership and performance evaluation schemes exerted a significant influence on transfer price predictions made by undergraduate students as surrogate managers. Participants with high ethical leadership conditions and cooperative performance evaluation schemes tend to promote transfer price predictions that are close to the equal profit price.

This study's main contribution is to exhibit that firms can manage transfer price negotiation conflicts with a highly ethical leadership style in the presence of a cooperative performance evaluation scheme. According to the research, firms with highly moral leaders can minimize the negative effects of interdivisional conflict by maximizing the positive effects of decentralization and cooperative performance evaluation schemes, such as improved decision-making and greater employee effort.

Literature Review and Hypotheses Development

Social Learning Theory and Transfer Pricing

The authors employ social learning theory in accordance with Brown et al. (2005) to elucidate this phenomenon. Bandura developed the social learning theory in 1977 to explain why and how moral leaders affect their followers. The foundation of social learning theory is the idea that people learn by observation and interaction with others in their social environment (Alavi et al., 2018; Brown et al., 2005; Ting, 2023). Many people typically look to others to learn about ethical behavior (Brown et al., 2005). Good leaders often set an example that attracts others to follow their behavior.

Social learning theory can be related to the way firms organize their transfer pricing (Chong et al., 2018). If a firm has a good reputation for business ethics and tax compliance, its subsidiaries may take that example into account and strive to follow ethical transfer pricing practices. Conversely, if the lead firm tends to engage in dubious or unethical transfer pricing practices, subsidiaries are also likely to be affected by such behavior.

Hypothesis Development

Ethical Leadership and Transfer Prices

Fairness, equality, and social responsibility are values that are emphasized by ethical leadership, which defines success as both the process and the outcome. Directors who exhibit strong ethical leadership are likely to recognize the value of upholding equity in cross-divisional transactions and will set transfer prices to minimize unfairness or profit inequality. Fairness and integrity can be encouraged and upheld in an organizational culture that is created by ethical leadership. Division managers will be more inclined to try to set transfer prices that reflect the values that their directors have espoused in this kind of environment.

Division managers working under a director with strong ethical standards are likely to follow his lead in terms of behavior and decision-making. Division managers are likely to follow the director's lead if they take fairness and integrity into account when setting transfer prices. Fairness in internal transactions is one aspect of corporate social responsibility that is emphasized by ethical leadership. It may be more likely for directors who are aware of and uphold social responsibility principles to make sure that transfer prices are equitable for all parties involved in the business; previous researchers (Bai et al., 2019; Brown & Treviño, 2006; Chong et al., 2018; Mayer et al., 2012; Sikka & Willmott, 2010) have all conducted research that supports this. Drawing from the preceding explanation, the authors argue the subsequent hypothesis:

H₁: Division managers with directors who have high ethical leadership tend to predict transfer prices that are closer to the equal profit price than directors with low ethical leadership.

Performance Evaluation Schemes and Transfer Prices

Evaluation schemes that emphasize cooperation and equity tend to encourage collaboration between teams or divisions. In such an environment, managers are more likely to consider fairness in setting transfer prices, as the main goal is to achieve mutual success and promote equality among divisions. In an evaluation environment that emphasizes competition and individual achievement, managers tend to focus more on their personal or divisional success. In this context, they may be more likely to prioritize greater gains for themselves or their division rather than considering equity or fairness in transfer pricing. This is in line with prior research (Chang et al., 2008; Chong et al., 2018; Ghosh, 2000a, 2000b). Drawing from the preceding explanation, the authors argue the subsequent hypothesis:

H₂: Managers evaluated under cooperative schemes tend to predict transfer prices that are closer to the equal profit price than managers evaluated under competitive schemes.

Ethical Leadership, Performance Evaluation Schemes, and Transfer Prices

It is thought that managers who report to directors or supervisors who exhibit high standards of moral leadership are setting an example of moral behavior and sound judgment. The social learning hypothesis states that managers tend to emulate the values or actions of those they see. When making decisions, especially regarding transfer pricing, they are more likely to take justice, equality, and truth into account if their leaders demonstrate strong ethical behavior. Plans for evaluating cooperative performance include a strong emphasis on equality, collaboration, and shared achievement. Manager's conduct will be influenced by a cooperative work environment. Because justice and equality are valued and reinforced in their workplace, managers in these cooperative workplaces may be more inclined to take these factors into account when determining transfer pricing.

The combination of high ethical leadership and a cooperative work environment will have a significant impact on managers' behavior in setting transfer prices close to the same profit price. Based on social learning theory, division managers tend to consider the values observed in their environments and models. In this case, experience with high ethical leadership and a cooperative work environment will influence how managers can more fairly predict transfer prices and approach the same profit price. This argument aligns with research (Chang et al., 2008; Chong et al., 2018; Garengo & Betto, 2022; Ghosh & Boldt, 2006; Ting, 2023). Drawing from the preceding explanation, the authors argue the subsequent hypothesis:

H_{3a}: Managers with high ethical leadership and evaluated under cooperative schemes tend to predict transfer prices that are closer to the equal profit price than managers with high ethical leadership and evaluated under competitive schemes.

H_{3b}: Managers with low ethical leadership and evaluated under cooperative schemes tend to predict transfer prices that are closer to the equal profit price than managers with low ethical leadership and evaluated under competitive schemes.

The social learning hypothesis states that division managers can learn from role models and examples of superiors who demonstrate high standards of moral leadership. It is common for managers to imitate or adopt the attitudes and behaviors seen in their role models. A cooperative performance evaluation plan emphasizes fairness, collaboration, and shared success. According to the social learning hypothesis, leader behavior is thought to be influenced by an atmosphere that fosters collaboration. Because justice and equality are valued and reinforced in the workplace, managers in such collaborative situations are more likely to consider these factors when setting transfer prices. Managers' behavior in setting transfer prices close to the same profit price is strongly influenced by a combination of high ethical leadership and a supportive work environment. This argument agrees with research (Chang et al., 2008; Chong et al., 2018; Garengo & Betto, 2022; Ghosh & Boldt, 2006; Ting, 2023). Drawing from the preceding explanation, the authors argue the subsequent hypothesis:

H_{3c}: Managers with high ethical leadership and evaluated with cooperative schemes tend to predict transfer prices that are closer to the equal profit price than managers with low ethical leadership and evaluated with cooperative schemes.

H_{3d}: Managers with high ethical leadership and evaluated with competitive schemes tend to predict transfer prices that are closer to the equal profit price than managers with low ethical leadership and evaluated with competitive schemes.

Research Method

The sample in this study consisted of third-year undergraduate economics and business students at universities in Indonesia. This study took a sample of undergraduate students as a substitute for managers in this behavioral accounting research. Many studies have done the same thing (Fisher et al., 2000; Fisher et al., 2002; Kachelmeier & Towry, 2002; Webb, 2002). Using college students as surrogates is appropriate, as the observed tasks involved simple information processing and decision-making (Ashton & Kramer, 1980) and, thus, did not require specialized skills. Many accounting studies have recruited university students for their experimental research (Blaufus et al., 2017; Donnelly et al., 2021; Song et al., 2022; Vinson et al., 2020; Webb, 2002; Xia & Han, 2021) and have found that the involvement of university students does not violate the internal validity of the experiments. Previous studies have also proven that such students are suitable as experimental samples in the case of transfer pricing Chong et al. (2018). However, eight participants (9.41%) who participated in the experiment did not pass the manipulation check. Thus, there were 77 participants (90.59%) whose data could be continued for processing. The demographic characteristics of participation were 27 males (35.06%) and 50 females (64.94%).

Experiment

This study used a between-subject 2x2 factorial design. The experimental design can be seen in Table 1.

Table 1 Experiment Design

Performance Evaluation Schemes	Ethical Leadership	
	High	Low
Cooperative	Cell 1	Cell 2
Competitive	Cell 3	Cell 4

The experimental process was carried out through laboratory experiments. Here is the procedure that must be done. First, participants were conditioned in a room. Then, the researchers provided instructions and rules during the experiment. Participants were given a research form containing a series of scenarios and several questions to be answered. In the first part, participants were asked to fill in personal data, such as name, cell phone number, current education, age, and gender. In the second section, participants were given a transfer pricing scenario. The information explained that they would play the role of a division manager of a company. They were given a management scenario explaining that each division was advised to transact internally by selling components to other divisions within the company because the company would get high potential profits. In the third part, participants were then given scenarios related to performance evaluation schemes and ethical leadership. Then, participants were asked questions about the predicted transfer price they would choose. Participants were asked to choose one of the transfer pricing options.

Manipulation Check

The authors conducted a manipulation check through four questions. The first question ensured that participants understood their position in the company. The second question was whether participants understood and were aware of the characteristics of their board of directors (senior management). The third question was to ensure that participants understood the basis for determining the bonus to be earned. Finally, it measured the seriousness of the participants in working on the given experimental scenario. Initially, 85 participants participated in the experiment, but eight participants did not pass the manipulation check. Thus, the number of participants at the end of the experiment was 77 participants.

Result and Discussion

Table 2 displays descriptive statistics containing the number of participants, as well as the mean and standard deviation of transfer price predictions for each independent variable. The group mean in the scenario of high ethical leadership and cooperative performance evaluation scheme was 4.00 (SD = 0.00), the group with low ethical leadership and cooperative performance evaluation scheme was 3.50 (SD = 0.52), and the group with

high ethical leadership and competitive performance evaluation scheme was 3.00 (SD = 0.00). The group with low ethical leadership and competitive performance evaluation scheme was 1.33 (SD = 0.49).

Table 2 Descriptive Statistics

Performance Evaluation Schemes		Ethical Leadership		Total
		High	Low	
Cooperative	Average	4.00	3.50	3.77
	SD	0.00	0.52	0,43
	N	18	16	34
Competitive	Average	3.00	1.33	2.42
	SD	0.00	0.49	0.85
	N	28	15	43
Total	Average	3.39	2.45	
	SD	0.49	1.21	
	N	46	31	

In Table 3, the two-way ANOVA test was used as a comparison of means between groups that had been divided by two independent variables. This study had two dependent variables, i.e., ethical leadership and performance evaluation schemes. The ANOVA test results above reveal that the Sig. value of ethical leadership was 0.000 < 0.05, meaning that the variable of ethical leadership influenced transfer pricing predictions. The performance evaluation scheme variable was also found to have an effect on transfer price prediction with a Sig. value of 0.000 < 0.05. The table also exhibits an interaction between ethical leadership variables and performance evaluation schemes on transfer price prediction with Sig. 0.000 < 0.05. To answer the hypothesis, simple effect analysis was conducted using contrastive analysis.

Table 3 Two-Way ANOVA Test Results

Variable	Sig.
Ethical Leadership	0.000
Performance Evaluation Schemes	0.000
Ethical Leadership* Performance Evaluation Schemes	0.000

Data were analyzed using analysis of variance (ANOVA) to test main effects and interaction hypotheses. The results of the hypothesis tests are presented in Tables 3 and 4. While Table 3 shows the results of the main effects analysis, Table 4 reveals the results of the simple effects analysis.

Table 4 Results of Contrast Analysis (simple effect)

	Hypothesis	Average Difference (Mean Different)
H ₁	High ethical leadership (Cell 1 + Cell 3) VS low ethical leadership (Cell 2 + Cell 4)	0.94
H ₂	Cooperative performance evaluation scheme (Cell 1 + Cell 2) VS competitive performance evaluation scheme (Cell 3 + Cell 4)	1.35
H _{3a}	High ethical leadership with cooperative performance evaluation scheme (Cell 1) VS high ethical leadership with competitive performance evaluation scheme (Cell 3)	1.00
H _{3b}	Low ethical leadership with cooperative performance evaluation scheme (Cell 2) VS low ethical leadership with competitive performance evaluation scheme (Cell 4)	2.17
H _{3c}	High ethical leadership with cooperative performance evaluation scheme (Cell 1) VS low ethical leadership with cooperative performance evaluation scheme (Cell 2)	0.50
H _{3d}	High ethical leadership with competitive performance evaluation scheme (Cell 3) VS low ethical leadership with competitive performance evaluation scheme (Cell 4)	1.67

This study supports hypothesis H₁ that high ethical leadership predicts transfer prices closer to equivalent profit transfer prices than low ethical leadership. The data in Table 2 indicate that participants with high ethical leadership scores set transfer prices closer to equivalent profit prices. Brown and Treviño (2006) stated that leadership remains largely unexplored, thus offering opportunities for researchers to discover new discoveries and opportunities for leaders to increase their effectiveness. This research provides new findings that ethical leadership can influence transfer pricing carried out by managers. This proves Brown and Treviño's (2006) proposition that ethical leadership is positively related to ethical decision-making. Hypothesis H₂ was also supported, with ANOVA results showing that performance evaluation schemes have an influence on transfer price predictions. Participants who were evaluated using the cooperative scheme had higher scores compared to the competitive scheme and performance evaluation scheme. The findings of this study are in line with prior studies (Chang et al., 2008; Chong et al., 2018; Ghosh, 2000a, 2000b).

Hypotheses H_{3a} and H_{3b} tested the interaction between ethical leadership and performance evaluation schemes. The results uncovered that high ethical leadership and cooperative schemes tend to predict transfer prices closer to equal benefit prices than competitive schemes, supporting H_{3a} and H_{3b}. Hypotheses H_{3c} and H_{3d} were also supported. As such, managers with high ethical leadership and cooperative evaluation schemes tend to predict transfer prices closer to equivalent profit prices compared to managers with low ethical leadership. These results hold also for the competitive scheme, supporting H_{3c} and H_{3d}. The interaction between ethical leadership and performance evaluation schema was significant, indicating the importance of ethical leadership in predicting fair transfer pricing.

The results of this research are similar to those of Chong et al. (2018), who found that tone leadership had a significant influence on divisional decisions to determine fair

transfer prices. In comparison, this research shows that another type of leadership, ethical leadership, can also influence the transfer price that the manager will set. The results of this research are similar to those of Chong et al. (2018) because tone leadership and ethical leadership are closely related. Good leadership patterns usually reflect ethical leadership principles, and these two concepts work together to create a work environment that is fair, transparent, and has integrity. Other research that supports these findings is by Brown and Treviño (2006), who reveal that ethical leadership contributes to more just and ethical organizational behavior. As they stated, "Ethical leaders communicate ethical standards and use rewards and punishments to ensure these standards are followed" (Brown & Treviño., 2006). However, the difference with some other studies, such as research by Avolio and Gardner (2005), is that they found that ethical leadership does not always influence transfer pricing decisions directly but through the mediation of other factors such as organizational culture and incentive structure. Avolio and Gardner (2005) highlight that "authentic leaders influence follower attitudes and behaviors through the establishment of an ethical climate and a transparent communication style."

The practical implications of this research suggest that organizations should consider the importance of ethical leadership and cooperative performance evaluation schemes in establishing fair transfer pricing policies. This can increase trust and collaboration between divisions, which can ultimately improve overall organizational performance. Theoretically, this research strengthens the concept that ethical leadership and cooperative performance evaluation are essential factors in making fair decisions in a business context. This research also paves the way for further research on how the combination of various organizational factors can influence complex managerial decisions such as transfer pricing.

Under social learning theory, which suggests that these managers tend to adopt the observed behaviors or values of their models, the influence of high ethical leadership and cooperative evaluation schemes may work together to create transfer price predictions that are close to the equal profit price. High ethical leadership can create a strong influence on managers' behavior. Even in a competitive environment, the adoption of ethical values from superiors may encourage managers to predict fairer transfer prices. Therefore, all three hypotheses in this study were supported. This study contributes knowledge to the ethical leadership literature by examining the influence of ethical leadership and performance evaluation schemes on transfer pricing. Previous research on leadership and transfer pricing predictions is limited and mainly focuses on tone leadership. As such, this study also enriches ethical leadership and performance evaluation schemes in transfer pricing prediction by using an experimental design. This research contributes to the practical implications related to transfer pricing by providing an easy and low-cost alternative control mechanism to reduce conflicts that can occur in the transfer price negotiation process.

Conclusion

The study examines the effect of ethical leadership and performance evaluation schemes on transfer pricing negotiations. The results unveiled that high ethical leadership leads to transfer prices closer to equal profits, and cooperative performance evaluations result in similar outcomes. Ethical leadership combined with cooperative evaluations can effectively manage conflicts and improve decision-making, benefiting organizational effectiveness. This research extends the literature on negotiated transfer pricing by considering social and economic factors. Overall, it highlights the importance of ethical leadership and cooperative evaluation systems in achieving organizational goals and effectiveness in transfer pricing negotiations.

The study acknowledges several limitations. Firstly, the experimental setup lacked direct negotiation involvement and actual monetary consequences, potentially limiting the realism of the decisions made. Future studies can explore face-to-face (e.g., Chalos & Haka, 1990; Ravenscroft et al., 1993) or computer-assisted negotiation methods (Kachelmeier & Towry, 2002). Secondly, this research was limited to ethical leadership styles and limited transfer pricing mechanisms. Hence, future research can use other leadership styles and other transfer pricing mechanisms, such as two-step pricing. Different mechanisms used may produce different decisions as well.

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Author Contributions

Conceptualisation, E.A.W. and F.S.N.; Methodology, E.A.W. and F.S.N.; Investigation, E.A.W. and F.S.N.; Analysis, E.A.W. and F.S.N.; Original draft preparation, E.A.W. and F.S.N.; Review and editing, E.A.W. and F.S.N.; Visualization, E.A.W. and F.S.N.

Conflicts of Interest

The authors declare no conflict of interest. The funders had no role in the design of the study; in the collection, analyses, or interpretation of data; in the writing of the manuscript, or in the decision to publish the results.



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