IMPACTS OF REVENUE SHARING, PROFIT SHARING, AND TRANSFER PRICING ON QUALITY-IMPROVING INVESTMENTS

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Abstract:

We compare different sharing rules and constant transfer prices in a buyer-seller setting, in which the incompleteness of contracts causes decentralization costs. The focus is on a situation where a manufacturing department or a supplier of an intermediate product can invest in a quality improvement of the final product and thereby increase its customer demand. We analyze the willingness of the supplier to invest under a revenue sharing rule, several profit sharing rules, and a transfer-pricing scheme. Our analysis shows that the performance of sharing rules is likely to decrease when there are less cost elements for calculating the basis of sharing. This is not true for the revenue-sharing rule. To the contrary, this less prominent scheme can be shown to maximize total profit under a variety of cost combinations.