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International Transfer Pricing
DO REGULATORY CHANGES DRIVE MANAGEMENT ACCOUNTING CHANGES?
Preliminary Insights From The Tax Director's Point Of View

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Abstract

The fiscal environment of transfer pricing is the starting point of this study, since transfer pricing regulations have become more and more strict and detailed over the last years. This recent increase in attention for transfer pricing matters by the national tax authorities offers an opportunity to investigate whether or not and in which way transfer pricing policy and managerial decision making evolve.

Exploratory case study research was used to investigate the changes in the transfer pricing policy and management accounting systems. The tax directors of 3 large multinational companies (MNCs) were interviewed in order to come to a first understanding of the importance of transfer pricing in practice. Based on these preliminary interviews, a number of observations can be made. First, the MNCs have to document the chosen transfer pricing system extensively towards the national tax authorities. The costs to comply with the external regulations have therefore risen drastically. Second, in an international context of increased regulations, the managerial function of transfer pricing policy is limited. Although all companies can prove that their fiscal transfer pricing policy is based on business grounds, the role of the resulting transfer price has been constrained. Transfer prices that are not 'at arm's length' are not accepted by the tax authorities. To some degree the managerial motivation of such alternative transfer pricing systems has to be taken over by other instruments of management control. The third observation is that MNCs increasingly try to avoid fiscal problems of transfer pricing when restructuring transactions: a number of internal relationships have been simplified so that they can be better followed and documented, and in some cases outsourcing has replaced formerly internal transactions.

While transfer pricing regulations are better motivated by business grounds than before, the rules have become so strict in a number of situations that they do not leave any space for a managerial implementation of the transfer pricing policy. These observations will be the basis for further investigation, which aims to develop a conceptual framework on the influence of the external regulatory environment on internal decision making.

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1. INTRODUCING THE RESEARCH QUESTION

Despite all the recent attention for transfer pricing issues, it stays complicated for practising managers to bring their international transfer pricing policy in accordance with two, often contradictory, sets of goals: the fiscal versus the internal management goals. The fiscal environment is the starting point for this study, since the transfer pricing regulations have become increasingly strict and detailed over the last years.

Since the early development of the fiscal rules, the focus has been on the requirement that transfer prices should be determined according to the arm's length principle. It means that transfer prices are accepted by the tax authorities if the same prices would also have been chosen for transactions between independent parties[1]. While "arm's length" continues to be the main principle in the fiscal regulations, the administrative burden has increased drastically during the last decade: both in the US as in Europe, the regulations dictate an extensive amount of documentation, including functional analyses and comparables. The better the documentation sustains the transfer pricing decision by the multinational company (MNC), the more the tax authorities are inclined to accept the policy. The functional analysis consists of an explicit comparison of the transactions undertaken by associated versus independent parties in terms of the functions, assets and risks involved. The chosen transfer price should be backed by comparables, referring to a range of prices that are made up of the prices that independent parties use when they undertake the same or a similar transaction. In order to control practice, an increasing number of national tax authorities are introducing transfer pricing audits, and are working out severe penalties for mistakes. At the same time, however, more and more countries offer advanced pricing agreements (APAs) for the multinationals, which imply that transfer prices are determined beforehand by the MNC and the tax authorities.

The broad interest of this research is whether and how the stricter fiscal rules influence the management control function of transfer pricing in MNCs. The recent increase in attention for transfer pricing matters by the national tax authorities, translated into extensive regulation, offers an occasion to investigate whether and in which way transfer pricing policies and managerial decisions are influenced. This paper reflects the results of an exploratory case study, in which the changes in international transfer pricing policy and management accounting systems in practice are documented and analysed. The results will be used as the basis for a grounded theory study about the extent to which and the reason why the internal system adapts to changes in the external factor. The final aim is to build a conceptual

1 The arm's length principle is incorporated in article 9 of the OECD Model Tax Convention.

framework that captures the influence of the external regulatory environment on internal decision making. The initial idea is the following:

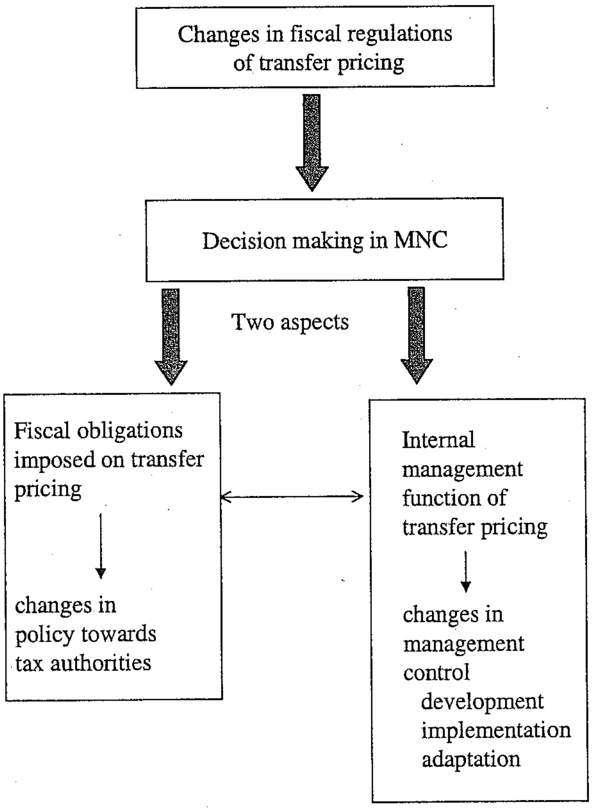

Figure 1: Overview of influences of regulatory changes on internal managerial decision making

The study starts from the fact that transfer pricing serves internal management goals while at the same time it has to fulfil fiscal obligations. Therefore, the influence of the augmented fiscal transfer pricing regulations is represented as a double impact in the figure. The consequences on the fiscal side are most visible: the MNC has to adapt its transfer pricing policy towards the tax authorities. The consequences for the managerial role of transfer pricing are not obvious: do these fiscal adjustments concerning transfer pricing also influence transfer pricing as a management control instrument? This research topic needs to be approached by paying attention to different levels within the organisation. While tax is typically a corporate theme, management control changes are experienced at the divisional and subdivisional level. International transfer pricing processes should therefore be examined both at headquarters level as at subsidiary and lower management level. Headquarters are especially involved in the development and corporate implementation of the transfer pricing policy, while the other levels basically implement the transfer pricing policy and, occasionally, they might ask for adaptation of the policy when it impedes the operational activities. As indicated in the figure, changes in the tax regulations could alter the relationship and the tensions between the managerial and the fiscal goals of transfer pricing at the different levels.

This paper is structured as follows. In chapter 2 the reader finds arguments that underline the importance of the research, while chapter 3 comments on a number of relevant contributions in the literature. Chapter 4 focuses on the research method, an exploratory case study in three large multinational companies based on a grounded theory approach. Chapter 5 represents the first impressions from the field, while the final chapter, chapter 6, indicates how this preliminary study will be followed up.

2. IMPORTANCE OF THE STUDY

Research in international transfer pricing is driven by the problems that MNCs encounter in practice. The academic response was at first normative and theoretical (economic analysis and mathematical programming) and concentrated on domestic transfer pricing issues. Since the 1970s and 1980s, transfer pricing started to be studied from a behavioural and an organisational point of view. This development led to an increasing number of positive studies, both investigating domestic and international transfer pricing. Recently, several empirical studies have used surveys to investigate the different pricing methods, as well as the primary objectives of international transfer pricing policies. A meta-analysis (Borkowski 1996) on transfer pricing research reveals that existing empirical work does not fully explain the relationships between environmental and organisational factors, and the transfer pricing method choice by multinational corporations. The aim of this paper, as well as of the broader investigation it belongs to, is to go beyond a mere enumeration of transfer pricing methods and objectives (Shih 1996). This study tries to *respond to the call for stronger theoretical contributions that explain how transfer pricing processes are actually managed* (Colbert and Spicer 1995).

In the second place, the issue of internal management is situated in a fiscal context in order to make a contribution in *closing the gap between 'accounting' and 'fiscal' studies of transfer pricing*. Until now, the regulatory environment has often been studied as a reason for international transfer pricing manipulation and income shifting[2]. Since it is still not well understood in which way political forces drive organisational change (Libby and Waterhouse

2 Some examples of international transfer pricing studies that focus on taxation are the articles by Jensen (1986), Halpirin and Srinidhi (1987), Grubert and Mutti (1989), Harris et al. (1991), Klassen, Lang and Wolfson (1993), Harris (1993).

1996), this study focuses on the influence of the change in fiscal rules on the international transfer pricing policy and the management control system.

In the third place, the aim of this paper is to provide *some insights in the implications of the new transfer pricing regulations*. Do the stricter fiscal rules decrease the distortions between the fiscal and the managerial role of transfer pricing? Several authors (Eden 1998, Hamaekers 1998) warn for the negative effects on the internal management of the firm. They observe in the US that the transfer price, preferred for managerial reasons, does not always fall within the transfer pricing range, accepted by the tax administration. The multinational enterprise is sometimes forced to calculate the expected cost of choosing a transfer price that distorts the resource allocation process, against the expected costs of the penalty. Since recently penalties are high, taxes play an increasing role in the decision making process. Do the stricter regulations push MNCs to use fiscally determined prices in their internal decision making? Such an observation would imply that the reach of the arm's length principle is overextended, and that the implementation of arm's length by the fiscal authorities misrepresents the purposes for which the arm's length principle was designed (Eden 1998).

3. RELATED LITERATURE

In the *managerial* literature, transfer pricing is considered as a part of the management control system. In this context, the two main objectives of the transfer pricing policy of the firm are the promotion of goal congruence and the provision of a suitable system of performance measurement and evaluation in the company (Benke and Edwards 1980). Both goals are driven by internal management needs, although their simultaneous implementation can lead to internal contradictions. Important aspects of transfer pricing as an instrument of goal congruence is its role for decisions on the efficient allocation of resources and on strategy (such as gaining competitive advantages in new or existing markets), and to the related make-or-buy decisions. Performance measurement and evaluation is related to the remuneration of the employees (Leitch and Barrett 1992).

The *fiscal* literature focuses on the contribution of transfer pricing systems concerning global profit maximisation. The emphasis is on the following aspects that determine how the international transfer pricing policy is set up: corporate income tax rates, import duties, withholding taxes, profit repatriation policies, currency fluctuations, and the form of investments (Lin e.a. 1993, Plasschaert 1994). This paper is delineated by focusing in the first place on corporate income tax aspects of international transfer pricing, although it is clear that the other aspects play a role.

Transfer pricing has been approached from different theoretical angles. Significant contributions have been made from economics, the theory of foreign direct investment, income shifting concepts, agency theory, transaction cost economics, competitive advantage and the contingency theory. None of these approaches gives a satisfactory global answer to the research question. Instead all these theories highlight separate aspects of the basic theme. Although several authors (Eccles 1985, Spicer 1988) pointed out that transfer pricing policies have serious strategic and behavioural consequences, they recognise that there is a lack of understanding of the factors that condition the way in which managers handle transfer pricing. With a profound grounded theory study, prepared through this exploratory case study, the objective is to build a theoretical framework that responds to this lack. Is it possible to increase the insights in how the transfer pricing policy, as an aspect of management control, is determined in an international context where tax considerations play an important role? The 'transfer pricing system' in this study is defined along the lines of Leitch and Barrett (1992): decisions on pricing method and sourcing are incorporated, including production, operation and location decisions.

A number of contributions from the literature have guided the set-up of the empirical study. Borkowski (1992) captured the influence of the regulatory environment on the multinational's behaviour when determining its transfer pricing policy in a contingency framework. Based on survey outcomes, she explained existing transfer pricing practice by identifying and analysing the organisational and environmental variables that affect the choice of the transfer pricing method. Both in a domestic (Borkowski 1990) as in an international setting (Borkowski 1992) the contingency theory approach has been supported: there is not one 'correct' transfer price for all MNCs (Borkowksi 1992), each firm develops its own different optimal set of accounting and management practices, which are situation-specific and contingent upon the organisational and environmental characteristics of the MNC's operating environment. Figure 2 represents the determination of the transfer pricing policy by a number of organisational and external contingent factors.

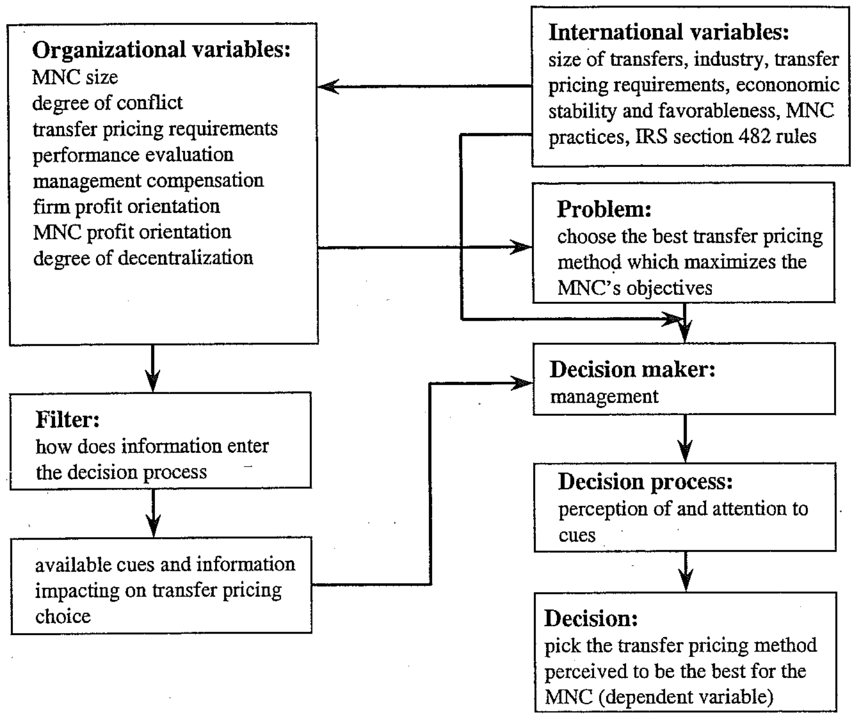

Figure 2: The contingency theoretic approach of the transfer pricing choice in an international environment, according to Borkowski (1992, p.183)

This paper singles out the fiscal aspect of the external environment, represented in figure 2 by the North-American transfer pricing regulations, the Internal Revenue Service (IRS) section 482 regulations. While Borkowski's contingency model studies transfer pricing decisions in a particular setting of specific circumstances, the aim here is to investigate how companies react when the environment changes: which evolutions or patterns can be identified? The focus is on 'changes' in the transfer pricing policy, since the processes of drawing up transfer prices and the related procedures and rules are at least as important as the prices, procedures and rules themselves (Swieringa and Waterhouse 1982). These processes of adaptation and learning are very dynamic (Eccles 1985). Colbert and Spicer (1995) stress that the study of organisational phenomena that are in the process of change provides a potentially powerful approach to understanding organisational relationships and dynamics.

While Borkowski's conclusions are based on survey studies, other authors have used case studies in order to capture the processes related to transfer pricing. In a domestic context, Eccles (1985) interviewed managers involved in transfer pricing in 13 firms in 3 industries. He found that strategy and the administrative process are the most important determinants of domestic transfer pricing practices. Eccles focused on micro-economic issues: strategy is characterised by the degree of vertical integration and the degree of diversification.

Spicer (1988) incorporated Eccles' ideas in an organisational theory on transfer pricing that explicitly took into account the whole transfer pricing process. As a result, Spicer developed a number of hypotheses on the relationships among diversification strategy, intra-firm transactions, organisational structure and management accounting and control systems. In the theoretical development, Spicer focused on two decisions about intermediate products: the decision about the design features or specifications of the product, and the decision to either make or buy the intermediate component. The variation in investment characteristics, the extent (frequency and volume) of buyer activity, uncertainty and complexity are all elements that explain the firm's choices of transfer pricing mechanisms and policy. In the line of Spicer's theoretical study of transfer pricing from a transaction cost economics perspective, Van der Meer-Kooistra (1993) made use of case studies to apply the transaction cost theory to domestic transfer pricing. Similarly, Colbert and Spicer (1995) refined Spicer's model into a theory of the sourcing and transfer pricing process. Their case study research revealed that the management of internal transfers and internal prices are indeed determined by the reported degree of transaction-specific investment (asset-specificity) associated with each transfer. Besides, there was a clear link with the strategic importance of the transferred component and the nature of the component division's production capabilities. The strategic role of transfer pricing, which became explicit when studying practice, has recently been incorporated in analytical models, such as the study by Alles and Datar (1998) in a duopolistic setting with the focus on the external role of cost and transfer pricing systems.

While the literature linking transfer pricing and strategy adds valuable insights, it ignores the international aspect and historical trends that move international transfer pricing. It would be useful to find out whether the increased regulation still allows for using transfer pricing as a strategic means. On the one hand, the stricter rules could impede the firm to implement its transfer pricing policy in a way that supports its strategic objectives. On the other hand, the new rules stress that transfer pricing policies, motivated with sound business considerations, should be respected. Similarly, the transaction cost approach is too static to answer the research question. Moreover, it does not explicitly pay attention to management control.

A number of very recent case studies have focused on international transfer pricing. In Elliott's PhD thesis (1999) the underlying relationships within the international transfer pricing process have been examined, leading to hypotheses on the importance of transfer pricing as a part of the dynamic process. The need for further case studies into the implementation and operationalisation of transfer pricing policies in MNCs becomes clear.

4. RESEARCH METHOD

CASE STUDIES

Case studies are chosen since they allow the researcher to take into account the complexity of the subject. Yin (1994) advises to use the case study method when the context is highly pertinent to the investigated phenomenon. For this study, it is important to understand the design and implementation of transfer pricing processes and their setting in specific organisational contexts. A research strategy based on case studies is generally preferred for situations where the 'how' or 'why' questions are more important than the 'who', 'what', and 'where' questions. In this way, an in-depth understanding of the decision-making process can be reached. When there is little control over events, case studies enable to integrate the study of historical events and documents, direct observation and systematic interviewing as important sources of evidence (Yin 1994).

The study focuses on changes in the internal management of the firm induced by the increased regulations. Processes should therefore be captured. Also Van der Meer-Kooistra stresses that 'transfer pricing systems are in a permanent flux, not only because of changing circumstances, but also because the parties involved learn as they go along. Changes in the formal regulations need time. Therefore, research into the functioning of transfer pricing systems has to take full account of the processes of change and adaptation, or the dynamics of the phenomenon' (Van der Meer-Kooistra 1994). At this stage of the study, in-depth field research is preferred to survey studies in order to come to a better understanding of transfer pricing processes and changes. Moreover, Colbert and Spicer (1995) reported that a lot of transfer pricing surveys tend to abstract from industry and organisational context and do not address the adequate level of the firm. This means that surveys are often directed at the level of the firm as a whole rather than at the subunit level where internal transfers actually take place. Besides, a sensitive topic like transfer pricing might cause serious response biases when a survey study is applied (Ferreira and Merchant 1992).

GROUNDED THEORY

So far, descriptive and theoretical contributions in the literature on the interaction between the fiscal and the management role of transfer pricing are scarce. The different angles from which transfer pricing has been investigated (such as the income shifting literature, transaction cost theory, foreign direct investment and others) lead to a fragmented view of the possible interaction between tax and internal management transfer pricing functions. The 'what', 'who' and 'where' questions have formed the starting point of this exploratory round, which should permit a gradual move towards the 'how' and 'why' of changes in the transfer pricing policy. This study will therefore start as an exploratory case study, to become explanatory in a further stage. The results of the initial investigation will be compared to other cases in order to build a solid theoretical framework. Fieldwork and the development of theory should be in continuous interaction. The research design is not fully structured in the starting phase so that it can be developed along with the field observations. This perspective leads the study towards a grounded theory approach, where the theoretical development is an emergent process. Grounded theory can reflect the richness and complexity of real accounting and management environments.

Grounded theory has been developed by Glaser and Strauss in 1967. Over the years, the two original authors have evolved in different ways, leading to two different schools of grounded theory. While Strauss and Corbin (1992) define grounded theory as 'a qualitative research method that uses a systematic set of procedures to develop and inductively derive grounded theory about a phenomenon' (Strauss and Corbin 1990 p.24), Glaser speaks of 'a general methodology of analysis linked with data collection that uses a systematically applied set of methods to generate an inductive theory about a substantive area' (Glaser 1992 p.16). In general, a grounded theory consists of a systematic analysis of documents, interview notes and field notes. All data are continuously coded and compared so that a well constructed theory can be formulated. Essentially, the theory and the data in which the theory is grounded, are intrinsically interrelated (Parker and Roffey 1996). The approach adopted in this study follows the ideas of Strauss and Corbin. It means that the research question is predetermined (although it can be refined based on the conclusions of this exploratory study), that the extant theory is used as a valuable basis for the study, and that the researcher is theoretically sensitised (Strauss and Corbin 1992).

The grounded theory process consists of three phases, used iteratively throughout the research process, instead of in a linear, sequential way:

- an inductive phase, in which first insights and generative questions are developed,
- a deductive phase, in which hypotheses are formulated, and
- a verification phase, in which the generated theories are verified.

The observations reported in this paper have to be situated in the inductive phase, which aims at opening up the inquiry. It should however be recognised that the distinction between the different phases is always artificial.

THE RESEARCH DESIGN

The aim here is to get an idea about the relevance of the original research question, as well as to enter into the grounded theory approach. In other words, the first phase of the study is useful to narrow down the research question. These insights are used to develop an initial theoretical model. The exploration is helpful to determine a number of constructs and to measure these constructs as accurately as possible. The constructs will be used to shape the initial design of the actual theory building. When several of the constructs, explicitly measured in the interview protocol and questionnaires, do emerge as related to the research topic, they could provide strong, triangulated measures in which to ground the emergent theory. However, no preliminary construct is guaranteed a place in the resultant theory, no matter how well it is measured (Eisenhardt 1989).

Before starting with the exploratory interviews in the selected MNCs, several external consultants in Western Europe were contacted and a number of their transfer pricing symposia were followed. These meetings confirmed the relevance of the research question from the consultants' point of view. It became clear that a number of consultants confine their work to fiscal advice and that they do not want to interfere with the internal management and business consequences.

The interviews in the companies were prepared by generating a list of questions (see appendix 1 for a broad overview). The topics discussed were based on a profound study of the OECD Guidelines (1979-1994) and the IRS 482 Regulations (1969-1992). The questions are open ended and used to guide the conversation and to make sure that the same themes were addressed during each interview. After the first interview the list has been updated slightly in order to incorporate a number of extra elements, brought up by the first interviewee.

Triangulation is one of the strengths of case studies. While interview data was the primary source of information, it was complemented with information from transfer pricing agreements, annual reports and other, more general information. Some elements were reported by the company itself, for example concerning its organisational structure, its products, markets and activities. Besides, the company's Internet sites have been consulted. In the context of grounded theory research, the following criteria to evaluate the quality of empirical social research are appropriate (Guba and Lincoln 1981, Elliott 1999):

- truth value,
- applicability,
- consistency and
- neutrality.

These elements have been carefully respected when preparing the questionnaire, checking the practical relevance, and when discussing the results with the interviewees. The criteria mentioned are closely related to Yin's (1994) standard criteria.

CASE STUDY COMPANIES

In the context of case studies, theoretical sampling instead of statistical sampling is relevant (Yin 1994). The use of a large number of multinational enterprises is confusing at this exploratory stage because it admits too many differences concerning inter-company strategy, location, global company performance measurement system, organisational culture etc. In order to address the research question adequately, the companies had to meet some general criteria: mature, large, and financially healthy MNCs of general public interest were searched for. In a way, best practice is expected from such a large enterprises. Earlier practical experience made clear that medium-sized and small multinationals would not have been suitable for this project, since their awareness and experience with the fiscal aspects of transfer pricing were often still very limited at the time the study started. It was however clear that also these smaller companies realised they had to become prepared to fulfil the fiscal compliance requirements within a short time.

The study therefore focused on the larger companies in each industry. All of them were leaders from the market or technological point of view. Accessibility determined to a great extent the choice, both in physical terms as in terms of the openness of management. The companies involved in this exploratory study were three large MNCs belonging to the manufacturing sector. Due to the confidential nature of the research topic, the identity of the MNCs, nor of its managers, can be revealed. Companies A and B have their headquarters in Western Europe, company C has its headquarters in the US, and all are characterised by a wide network of subsidiaries in most continents of the world. Limitation to one particular sector was impossible, since transfer pricing is a very sensitive area and top management is reluctant to provide information that would be contrasted to competitors' information. Company A is active on the business-to-business market, while the companies B and C are active both on the business-to-business market as on the individual consumer market.

The access was gained through the fiscal departments of the different companies. In company A and C, the interviews were held with the tax directors of a major product group, which means that the divisional level was involved. In company B, the interview was held at corporate level. The interviews took place in November and December 1999. While in companies A and C only one person was interviewed, the tax director of company B was assisted by two internal transfer pricing specialists with a consulting background. Beforehand, they received a 2-page general overview of the research intentions. The interviews with the companies B and C were taped, while the tax manager of company A did not like the idea of being on tape. A short summary of the characteristics mentioned here is represented in the following table.

MNCs preliminary study	A	B	C
Location of headquarters	Western Europe	Western Europe	US
Level interviewed	Divisional	Corporate	Divisional
Number of people interviewed	1	3	1
Sector	Manufacturing	Manufacturing	Manufacturing
Market	Business-to-business	Business-to-business + consumer	Business-to-business + consumer

Table 1: Overview of characteristics of MNCs involved in preliminary study

5. CONCLUSIONS FROM THE EXPLORATORY STUDY

The tax managers of the three interviewed companies were cautious not to reveal proprietary company information. For the divisional tax manager of company A the fear was that big that the interviewee did not want the conversation to be taped. Transfer pricing clearly still is a very sensitive topic, especially in the Western European context where the local authorities have recently started to increase the regulations and threaten with penalties for mistakes.

In the three cases, the transfer pricing policy is determined at the top level. In company A, the transfer pricing policy is designed per product group, because each product group addresses a different sector and each sector has its specific characteristics. The directors of the most important subdivisions in each product group discuss the development of the transfer pricing approach together in order to reach as much consensus as possible, but in fact headquarters are steering the whole discussion. The general transfer pricing policy is worked out in an interdisciplinary way, especially in the common field of taxation and finance. The policy is set up within the OECD framework. The lower levels in the MNC are allowed to take immediate implementation decisions, although mostly a representative of top management is involved. In principle, the product groups have the steering responsibility concerning their transfer pricing policy.

Similarly, in company B the overall transfer pricing strategy is developed at corporate level and worked out in detail for each product group specifically. The results for the different divisions have been gathered in one overall MNC transfer pricing document that clearly represents the company's standpoints. For the further implementation, there is a close cooperation between the highest level controllers and the controllers in the product divisions. The units cannot deviate from the global policy unless they discussed it with the policy makers of the MNC. Internally, company B has organised a number of control instruments in order to make sure that the imposed policy is followed in all the subdivisions. In company C, the transfer pricing policy is written down as a chapter in the more general controller's manual. The rules have to be followed very strictly, whereby consistency throughout the organisation is the most important motivation.

The three interviewed companies feel strong pressures from the regulatory changes. In several countries the regulations have become really strict, and also in most other countries the attention by the tax authorities has increased drastically. According to the tax director of company A, the fiscal situation has not changed that much compared to the past. However, he admitted that in a number of countries he is confronted with a stricter regulation (US, Germany, UK), which also leads to harder negotiations in the countries where the regulations have not been sharpened. His company is taking on a pro-active behaviour in this respect. The attitude of company B is even more pro-active. Corporate and divisional managers do not wait until they experience changes in the fiscal rules, but they try to be maximally informed and to prepare the company before new regulations have even been implemented. In company C however, where top management tries to make its transfer pricing policy as simple and consistent as possible, the general transfer pricing attitude is alert but rather reactive towards the current developments.

All interviewees consider the increased compliance requirements to be the strongest influence of the stricter regulations on their MNC. The demand for extensive evidence on the MNC's transfer pricing policy means that the companies must document their transfer pricing policies into detail. Most countries follow the OECD Guidelines in this respect, which recommend that a functional analysis is performed and comparables are provided. The functional analysis implies an explicit description of the functions performed by the parties involved in the particular transaction, the assets dedicated by both parties to the transaction, and the risks assumed by the different parties involved. These functions, assets and risks involved in the transaction between the associated parties needs to be compared to the functions, assets and risks undertaken by independent parties in a similar transaction. That the chosen transfer price is fair compared to how unrelated parties in the market would price (arm's length principle) should be proved by using comparables. Comparables are the prices or margins within a range of price/margins used by independent parties in the same or a similar transaction. The MNCs also have to respect the prices that are allowed by the national tax authorities. In some countries, the number of pricing methods is limited, while in other countries, a larger number of possibilities are allowed.

Another important observation is that, despite the stricter regulations, the tax directors still feel a large degree of uncertainty in the transfer pricing area, which they try to reduce in several ways. Most MNCs rely on the advise by external consultants for setting up their transfer pricing documentation. Some make use of the advanced pricing agreements (APAs) in order to come to an agreement with the tax authorities in the countries involved in the transaction before the transactions actually take place. Besides, a lot of companies make use of special software packages to provide comparables and to prepare their fiscal documentation. The three investigated MNCs confirm that for the comparables requirement they need the help of external consultants. Specialised consultants have cheaper access to commercial databases and have often set up their own internal comparables databases. As a result, compliance costs are inevitable, not only in terms of internal management time and effort, but also in terms of additional formation of staff and external consultancy costs. Also when advanced pricing agreements are discussed with the tax authorities, the costs are high: some tax administrations, especially the IRS in the US, charge large fees, comparable to external consulting fees, for the contact hours with the MNCs.

Table 2 summarises the topics discussed with the tax directors concerning the fiscal requirements.

MNCs preliminary study	A	B	C
Transfer pricing discussion	sensitive topic	sensitive topic	sensitive topic
Development transfer pricing policy	Corporate + Divisional level	Divisional level + Corporate Guidelines	Corporate level
Implementation transfer pricing policy	Divisional + subdivisional level, supervised by corporate representative	Divisional + subdivsional level, internal control by divisional level	Corporate level
Pressure from regulations ?	Very high	Very high	Very high
MNC behaviour towards tax authorities	Proactive	Very proactive	Reactive
Strongest influence of regulations	Increased compliance requirements + lot of uncertainty	Increased compliance requirements, esp. comparables	Increased compliance

Table 2 : Summary of responses to tax questions by the tax directors

Besides communicating observations on the influence of the regulations on tax practice, the aim of this exploratory study is especially directed to the question whether the fiscal regulations also have repercussions for the internal role of transfer pricing, more precisely for its management control function. In the three cases it was clear that the fear for audits and penalties has a large influence on the choice of the transfer pricing policy. In a domestic context the transfer pricing policy is determined by internal management motives, while in an international context, additional elements play a role. The tax directors focused on the special concern by top management with diminishing tax uncertainty and risk. The transfer pricing policy is less determined by strategic managers only, but is now also influenced by the in-house tax department, and, as explained above, by brand lawyers and external consultants. Both external groups often limit their contribution to the purely fiscal aspects of transfer pricing, without addressing internal management aspects. The interviews indicated that that the tax directors at the corporate and divisional level did not always know how the transfer pricing policy is implemented at the lower levels, and especially what the consequences are for management control. The ignorance by the tax specialists on the managerial influences can be explained by the task division in MNC. This observation however confirms that it is indispensable to involve operational managers and controllers in the discussion.

The fiscal transfer pricing regulations urge companies to provide solid justifications for their transfer pricing decisions. Economic motives are very appropriate and their increased use could theoretically have the effect that the traditional duality between fiscal and internal management objectives of the transfer pricing policy is partly cancelled out. The tax directors stressed that large MNCs are not able to let tax manipulation be the main driver for their transfer pricing policy since there always needs to be an economic or business oriented explanation of the system. In this context, two of the three interviewed tax managers were convinced that their transfer pricing policy follows the managerial transfer pricing needs. The director of company A, however, claimed that the fiscal and the management transfer pricing are two separate things.

On the other hand, all tax managers agreed that performance measurement and evaluation of managers and divisions cannot be based on the results of the transfer pricing policy. These responses seem to refer more to the traditional controversies between the different roles of transfer pricing as an instrument of management control, than to refer to the influence of taxation on internal management of the MNC. Goal congruence and related economic objectives of transfer pricing are not always at the same wavelength as performance measurement and evaluation objectives. The tax managers of the companies B and C explained that the divisions and subdivisions are evaluated on IFO, income from operations, and that the (sub)divisions are set up in such a way that the influence of the internal prices disappears from the calculation of IFO. The tax director from company A did not provide details. In the 3 cases, the managerial function of transfer pricing policy had been limited, which means that the performance measurement function of transfer pricing at the divisional and subdivisional level has to be taken over by other instruments of management control.

When discussing strategy the tax directors of the companies A, B and C did not see any strategic role for transfer pricing. The tax director of company C gave an example where temporary subsidies were used when needed to gain access to a new market. The strategic goal was therefore not reached through adaptation of the transfer pricing system, although a temporary exception is explicitly allowed by the OECD Guidelines and the IRS Transfer Pricing rules. Instead, the simple and company consistent transfer pricing system was kept in place and strategic objectives were realised using other, additional instruments of international operations.

Earlier experience showed that the management of medium-sized MNCs only started to be aware of the recent changes in the regulations, and was only very slowly trying to adapt the company's systems to these changes. In contrast, the interviewed tax people from company B stressed that large MNCs have always been in close contact with the tax authorities, and that tax people are coming in and out of the MNC for several other reasons than just transfer pricing. As a result, the company does not feel to have a lot of discretion to adapt its transfer pricing system according to its current needs, or to change the system drastically when it becomes fiscally more interesting. The transfer pricing director of company B stressed that its company is not involved in manipulating transfer pricing, but has as its primary goal to avoid double taxation. 'Political visibility' (Watts and Zimmerman 1985) could be an important element for explaining the behaviour of leading MNCs in the transfer pricing context, and could provide an interesting framework for the follow-up study.

Prior to these exploratory case studies, it was expected to find a clear influence of the stricter regulations on managerial decision making. The external information, gathered for fiscal transfer pricing purposes, could be incorporated in the management accounting system and used for other internal decision making purposes, such as for competition analysis (benchmarking) and for strategic cost analysis (for example make-or-buy decisions). The first observations suggest that two of the three companies (A and C) did not yet experience changes in the management accounting system, induced by the developments on the taxation side. Their tax departments were busy adapting the existing transfer pricing policy to the new compliance rules, and there had been no time to feel other implications than on international taxation issues. This observation confirms again that the changes in the fiscal rules ask a lot of time and effort from the MNC's management. In company B however, there were several influences from the fiscal situation on the business economics decision process. The tax department was convinced that taxation and business economics meet each other in the functional analysis. The functional analysis requires a clear representation of the flow of goods, leading to an explication of the relevant financial numbers at the different phases of the goods flow. In this way, the costs, revenues and/or margins involved in the transfer pricing calculation become clearly linked to what happens in the value chain. These requirements can become useful in a very complex environment in order to re-think the business chain.

Another observation is that profit maximisation of the MNC has to be realised under new conditions. As a result, restructuring and reorganisation have to be considered. The consultancy world (Atkinson 1998) claims that multinationals can give a role to transfer pricing planning in optimising supply chain profitability. Although the tax strategy should not influence operational business decisions, significant rewards can be reached based on a defensible and tax efficient transfer pricing restructuring. Since the functional analysis forces multinational companies to scrutinise their value chain, companies could become aware of the possibilities for supply chain reengineering. Reengineering refers to the fundamental rethinking and radical redesign of business processes in order to achieve improvements in important performance measures, such as cost, quality, service and speed. The modelling of the supply chain cannot only be driven by transfer pricing considerations, but also by changes in volume and forecasting risk, internal needs for restructuring, projects of pack-and-process rationalisation, integrated manufacturing, changes in costing methodology (e.g. ABC), and the influence of emerging markets as well as tax incentives (Atkinson 1998).

As far as the observations in the context of this paper, restructuring of transactions could be a means to avoid transfers and their pricing. The different companies have simplified a number of internal relationships over the last years, outsourcing has been used and increasingly, services were replacing traditional transfers. In this way a number of transfer pricing issues disappeared automatically. However, this type of restructuring is never taken out of the business context. In the few examples that came up during the interviews, the reorganisation of the transfer pricing transactions always took place during more general business reorganisations. The tax director of company C confirmed that restructuring is not a solution to the changes in the transfer pricing regulations, but on the other hand, when reorganisation becomes relevant in the business context, taxation and transfer pricing is one of the important factors in the decision making process.

6. FOLLOWING UP THE EXPLORATORY STUDY

Based on the exploratory case study, the following figure has been drawn:

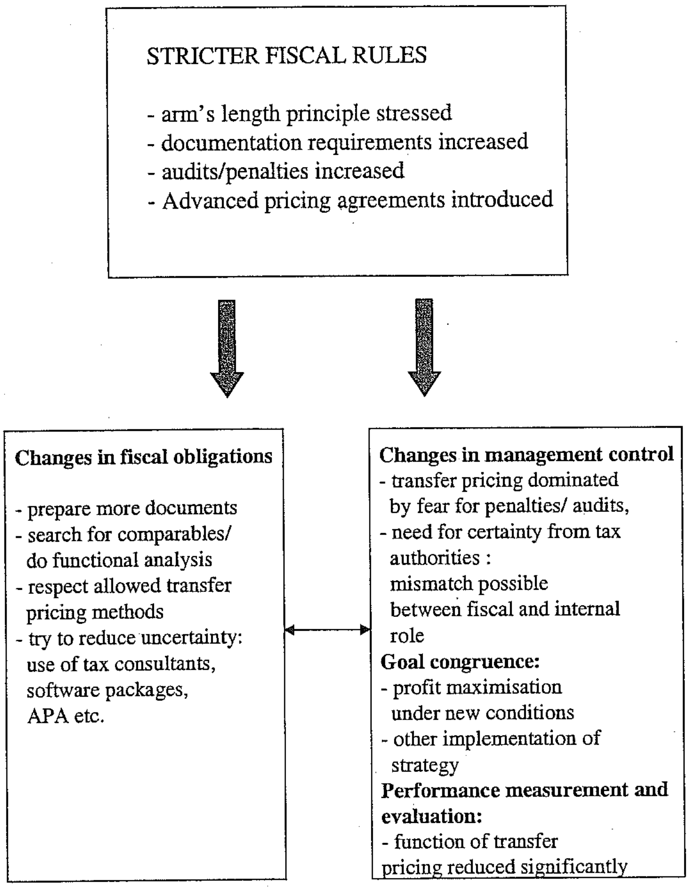

Figure 3: Concrete aspects of the influence of transfer pricing regulations on the internal decision making process in the multinational enterprise.

A clear interaction between the fiscal role and the management control role of transfer pricing has been observed. The fiscal rules impede that the MNCs develop and implement a transfer pricing system that is optimal from a management control point of view. Figure 3 summarises the first insights of the influence of the stricter fiscal rules on the MNCs. On the one hand, there is a directly observable influence on the firm's relationship with the tax authorities. The corporate and divisional tax department have to prepare extensive documentation, include a functional analysis and comparables. Moreover, they have to prove that the MNCs transfer pricing system respects the transfer pricing methods that are allowed by the tax authorities. In order to reduce uncertainty, tax consultants, software packages or the use of advanced pricing agreements with the tax authorities are of help. An additional observation in the context of uncertainty is that MNCs increasingly try to avoid fiscal problems of transfer pricing when restructuring transactions: a number of internal relationships have been simplified so that they can be better followed and documented, and in some cases outsourcing has replaced formerly internal transactions. All these elements indicate that the costs to comply with the regulations have risen drastically.

On the other hand, the influence on management control is significant. Transfer pricing issues are dominated by the fear for tax audits and penalties. Since the tax requirements play a larger role for transfer pricing issues, a mismatch between the fiscal and the internal management role of transfer pricing can occur. In the context of goal congruence, it is clear that the MNCs have to maximise profit under new conditions. Strategy objectives are often not fulfilled using transfer pricing, but alternative instruments are used. Moreover, the role of transfer pricing for performance measurement and evaluation has reduced significantly.

The figure above represents the first general conclusions and will be used to develop a conceptual framework regarding the influence of taxation on internal transfer pricing decisions. A dynamic interaction between theory and case-based observations will be central during the further stages of the study. In the tradition of grounded theory, the degree of reliance on the original framework needs to be kept under review. The framework in figure 3 is kept sufficiently wide so that relevant aspects can come in whenever they appear in the further investigation.

One of the most important conclusions in this exploratory stage of the study is that the unit of analysis should be the individual transaction. The main reason is that the tax authorities discuss transfer pricing at the transactional level. Moreover, information about the internal goals can be grasped more easily when focusing on individual transactions. Since the focus is on particular transactions, the choice of transaction cost economics as the basic underlying theory will be reconsidered. In order to limit the influence of differences such as organisational culture, top management style and other typical aspects, one MNC will be investigated in the next phase of the research. Operational, financial, tax and human resources managers will be interviewed at different levels of the MNC. Company B of the three original multinationals has been selected because it complies in the most pro-active way with the fiscal requirements. It is the most useful research subject to investigate the influence of tax on management control. The conclusion of this exploratory study is that the stricter fiscal rules do indeed have a major influence on the management control function of transfer pricing in MNCs. The following in-depth study of a number of transactions in the chosen MNC will be used to gain insights in how this influence works and how both roles of transfer pricing have to be understood.

Appendix: Overview of the interview questions in November 1999

How is the transfer pricing policy in the MNC developed?

How did the transfer pricing regulations evolve over the last few years? In which respects did you notice this change in your company?

The new regulations impose the use of economic data in order to motivate the MNC's transfer pricing policy : functional analysis, search for comparables, increased documentation. How do you handle these requirements in the MNC?

In which respect is this new information, needed for the fiscal compliance, useful for internal management decisions?

Do the stricter regulations have an influence on your internal decision making ? What is the influence of the stricter regulations on the evaluation of divisions and activities, and related, on the performance evaluation and remuneration?

Could you call your adaptation of the transfer pricing policy a pro-active or a re-active movement?

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