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A Survey on Transfer Pricing Practices in Manufacturing Sector of Pakistan

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Abstract

The aim of this study is to examine the most dominant transfer pricing methods and the structure with line of responsibility for transfer pricing decisions as used by different manufacturing companies in Pakistan. It reviews the regulatory developments made on the issue of transfer pricing in context of Pakistan. It also aims to investigate some explanatory factors influencing a company's transfer pricing method choice. A questionnaire is used to collect the required information from sample companies. The dependent variable of the study is choice of transfer pricing methods and the independent variables are company size, degree of decentralization, degree of diversification, and size of transfers. Sample of the study is taken from listed companies of Karachi stock exchange and Lahore stock exchange. Results of study have differences with previously conducted studies in other parts of world. Chi-square test shown that, there is less significant relationship between the used variables and the transfer pricing methods' choice, rather it seems to have interfering impact of others situational variables like regulatory framework, tax, earnings management etc. However some more tools and techniques are required to reach true contextual drivers.

Keywords: Transfer Pricing, Pakistan, Market Value, Cost

JEL Classification Codes: M41

1. Introduction

After entering into the new era of competition, efficiency and other management goals, now companies have two types of customers; one is external and other is internal. The purpose to consider other functional or product department as their customer is to maintain an environment of competition between with-in company units, and to improve overall efficiency of organization. When certain goods or services are transferred by department/division/branch to another then certain accounting is required in the books of accounts. Using transfer pricing aligns with above mentioned goals. Transfer prices have been defined as the monetary values assigned to goods and services transferred between the units of the same company; (Casts-Baril et al., 1988). Another definition was presented by Wells, (1968); the monetary expression of a movement of goods or services between units/divisions of the same organization. In other we can say that transfer pricing is negotiated value placed on goods and services between related companies or departments within the company. Normally these transactions are neither related to the market conditions nor do they represent market prices of goods or services, but still pricing may be based on the market or other then market. Notably, 66% of managers of different companies used in the studies are of the view that their transfer pricing is non-market based.

1.1. Transfer Pricing Methods

Many practices are used for the purpose of transfers. However widely used practices are following:

- Market-based
- Full cost-based,
- Variable cost-based
- Negotiated price

In market-based transfer pricing, transfer pricing based on market prices. In a fully competitive market for goods and services bought and sold between departments within the organization must transfer prices are market prices. Selling price is slightly lower than the market price and distribution costs are lower than the cross-border payments, because there is no cost advertising for transfers between divisions. There is a problem for managers in the market price may vary.

The main disadvantage is that the market prices, market prices are not always available for internal transfer elements. Another disadvantage of transfer prices based on market prices of certain products and services can vary significantly and quickly. Companies sometimes try to defend this great leader unpredictable price changes.

If the market is not competitive outside, but stable, the decision-making process is distorted by the use of transfer prices based on a market where competitors are selling emergency or participate in one of the many strategies involved in the specific prices (discrimination price, for example, the tie-in entry deterrence product). In addition, the dependence on market prices, it is difficult to protect the child segments.

Microeconomic theory shows that an increase to deal with the struggle for profits, market-based transfer prices in accordance with their wages to profits for the owners to maximize the total return on the face of society. The transfer will come into force when in the best interest of shareholders, and will not be sent at least one field director in the General Assembly for the transfer is more likely to be refused. his amount is usually indifferent to receive market prices for external customers and internal customers receive the same price, because the provision is whether the subdivision are willing to pay market prices or not. If the subdivision is ready for this, which suggests that the subdivision are additional benefits for companies with the purchase of goods of first division, and sell or use the product in its own production activities. On the other hand, the division is able to pay the market price, is the suggestion that corporate profits are greater than before the division sells products in foreign markets, even if the subdivision inactive.

Full cost transfer prices are set by full cost pricing but do not contain a profit margin for the providing the products to other division. This method is extensively used in practice. However, there can be problems for managers if they do not have correct cost information, which may lead to poor decision making. About half of the major companies in the world transfer items at cost.

Other known methods of transfer pricing are cost plus, variable cost plus lump sum charge, variable cost plus opportunity cost, dual transfer pricing, and negotiated transfer pricing.

1.2. Transfer Pricing and Related Regulatory Provisions in Pakistan

Securities and Exchange Commission (SECP), the company law authority of Pakistan was held in the context of transfer pricing, in 2003, trading rules and listing of Annex IV of Council Regulation, 1984. Stages of growth and adaptation in relation to the needs of application of transfer pricing are as follows:

December 31, 2002: SECP as adjustments in Annex IV, as it was clear that all other expenses that the price will be market conditions, lead, distorting the true picture of the company are recognized.

January 02, 2003: Updates and changes in 4th Schedule is an effective way from

January 22, 2003: The arm's length prices, transfer pricing and related companies have been combined with the need for full disclosure. In a nutshell, the requirements, if the rules are the rules of the market price for the treatment of paper and ignore this rule requires the consent of BOD and Audit committee were held.

January 21, 2003: The changes are for the specific purpose of SECP rules for registration of transfer pricing rules are an integral part. The fourth requirement was attached to the light of the information contained in the budget while the auction rules also contain procedures for the uniform advice on related party transactions and transfer pricing decisions.

February 14, 2003: The structure of the audit report has been approved for accounts report on compliance with the operational needs of transfer pricing. This was done by SRO No. 167 (1) / 2003 02/14/2003 dated. This version is still on the floor and is suspended or resigned. But neither there nor compliance with the independent SECP are satisfied.

February 25, 2003: Rules notified by the Stock Exchange.

August 07, 2003: The above statement of 21 January 2003, replaced with fresh, fair. Some relaxation of transfer pricing has been achieved by this. January 28, 2004: Replacement of the SECP, the obligation of filing the inspection and certification of compliance with best practices accounting rules at the beginning of October 2003, the first time.

January-May, 2004: Several companies and ICAP OICC and alive with a variety of compliance issues. Commission in the SECP has been appointed to consider the application.

June 03, 2004: "The Commission presented its report and made the following recommendations: -

Commission may apply the provisions for related party transactions and transfer pricing in Table IV and registration for a period of six months. Meanwhile, the necessary consultations with stakeholders have led to the SEC on board approach to the problem of transfer pricing approach and improve the legal requirements for transfer pricing, if necessary, to achieve.

Requirements for transfer pricing, determined in consultation with stakeholders, serves both the rules of use powers under Article 506 of the Companies Act, 1984 declared and presented in accordance with the law firms section 246, 1984.

July 05, 2004: The 4th Schedule was alternate vide notification SRO 589 (I) / 2004 of July 5, 2004, to replace. The sales accounting for related party transactions and transfer pricing, and identify the different methods of calculating prices fell.

November 12, 2004: Promoting reflection questions remain objective, SECP made the notification / Directive on the exemption for companies and their subsidiaries, according to the agenda of transfer pricing in 1984 and the auction rules. This exemption continues to apply, and is now December 31, 2005.

2. Literature Review

Turney (1977) worked for conceptual development of a cost based transfer pricing system to be used for services of the corporate management information systems (MIS) department. The proposed system is based on a five part transfer price. A change is levied for each four groups of costs differentiated according to cost behavior and traceability. A fifth charge is a non-cost based on a groups of costs differentiated according to cost behavior and traceability. A fifth charge is a non-cost based congestion charge designed to equalize short run fluctuations in demand for the computer facilities. The transfer pricing system is designed to be consistent with accounting theory yet operational within the constraints imposed by the environment. Any system of transfer pricing for MIS is constrained by the difficulty of treating MIS as a profit center and in the methodological difficulty of judging economic and behavioral impact of any transfer pricing algorithm. Much of the early part of the article is spent determining just how, and on what basis the transfer price should be chosen. The four-part transfer prices are, a separate charge for congestion, development, variable and step-variable costs, is chosen on the basis of relevancy.

Merville and Petty (1978) analyzed several aspects of the international business environment which affect the setting of a transfer price. These items include the various methods and rates of income taxation; quotas and duties imposed on imported materials; capital flow restrictions and currency regulations imposed by a host government; and managerial preferences for risk avoidance through deliberation of risks related with foreign exchange rate fluctuations, rates of inflation and nationalization. Also the behavioral aspect of managerial rewards and controls must be considered in the transfer pricing problem. Since transfer prices usually cannot be set to achieve all of these goals at once, some means must be devise by which the firm's multiple objectives are optimized. In this vein, the transfer pricing problem is created in both a single-objective and a multiple-objective approach for evaluation purposes. Specifically, the transfer pricing problem is couched in both a linear programming and a goal programming frame-work to allow for the optimization of differing tax rates, profit requirements, and experience and nationalization risks around the world.

Cravens & Shearon (1996) aimed to determine if international transfer pricing affects the outcomes of transfer pricing objectives. From 82 US-based MNCs useable responses (a 16% response rate) that excluded non-US based and financial MNCs, the results showed that 42% of respondents used cost-based methods, 33% used market based methods, 18% used negotiated pricing, and 7% used multiple methods. It was apparent that the MNCs attempted to achieve multiple objectives through their transfer pricing decisions but management of overall tax burden objective was the most important when determining international transfer pricing practices. Nevertheless, there were other critical objectives, such as evaluation and performance. The dollar value of international transfer and the foreign sales percentage were significant explanatory variables for the financial outcomes of these objectives. This is so, because the size of internal transfers and external sales has a direct effect on the financial outcomes of the firm.

In McGaughey (1997) key question was “What are the key factors that influence the system of transfer pricing in some areas?” It investigated the pricing practices of electronic transfer and chemical operations selected national and international companies, the response of 247 international companies receive. Studies have shown that companies that use chemicals most commonly used transfer pricing in the electronics industry and has been used is no significant difference between the methods of transfer pricing guidelines for the chemical and electronics companies. The results of the assessment and classification of the role of cyclical factors, the results showed that the main factors affecting the choice of transfer prices for both companies will benefit as a whole, the constraints imposed by foreign countries and the competitiveness of the department of foreigners. Cravens (1997) examined the strategic objectives of international transfer pricing in multinational companies in America. The results showed that, based on business costs (42%), market (33%), trade (18%) or twice the rate (7%) were used. Use 82 responses (21%) are the main objectives of management, to maintain tax competitiveness are met. Cravens noted that the multinationals have the same transfer pricing method to use domestic and foreign transfers. During the internal objectives, such as job evaluation, motivation and support the objectives of social leaders that in the month of September in the transfer line purely national, even international companies to achieve these objectives for international transfers. Borkowski (1997) examined the contrast with previous results, it seems Japanese transnational corporations (TNCs) have their preferences have changed the method of the cost of international transfer pricing method based on a market-based negotiations. The use of the negotiated procedure is supported by the Japanese preference for collectivism and consensus. The main risk associated with the TNC surveys U.S. Internal Revenue Service of the United States and Japan National Administration, in conflict with the official policy of both the tax authorities, the methods are based on costs, the theoretical methods in line with the market. Since in practice, however, cost control methods according to the IRS more than two times higher than other methods, suggesting that the IRS take the best method, in fact, methods of market acceptance and methods of negotiation on basis of market prices.

Vaysman (1998) proposes a Model to negotiate transfer pricing, in which personal information manager. I document two important facts. Premier HQ is a guide to collective bargaining and compensation, the original results of the negotiations on the management of transfer pricing. It uses a system of compensation for the second transfer pricing negotiation enables companies to maximize profits. These results are very attractive. The Company may delegate the decision-making and freedom of the director, transfer pricing and money transfers to be negotiated, but with a determination of damages, to obtain the maximum profit. Using different extensions vast majority of listed companies to transfer pricing, decentralization but this method yet well understood. This study developed a model of negotiated transfer pricing international private information, as this setting, where decentralization is very interesting. The company designs a compensation scheme, to evaluate the results of the chef to use transfer pricing and negotiation. Dynamic trading model is used to negotiate with superiors. The survey shows that companies can pay systems of management and trading platforms, so that makes the structure of transfer pricing negotiations to obtain the maximum benefits available. Alles and Datar (1998) document provides a different approach in this model where two oligopolistic firms the strategic choice of transfer prices based on costs. Duopoly models typically assume that firms choose prices. Product prices are ultimately based on the company, transfer pricing and the costs of marketing communications. For this reason, the transfer price is a strategic factor for them. Influence the choice of effective systems and transfer pricing, companies also show that cross-promote their products, resulting in consistent with the empirical data.

Gabrielsen and Schjelderup (1999) distinguished approaches to transfer pricing for businesses, the supply of goods in general, in the hands of the manufacturer of the final good. They believe that the properties of commodity prices (transfer prices) are evaluated changes in the prices of raw material suppliers horizontally integrated, resulting in lower overall profits of integrated firms. The reason is that each co-owner of the competition off the fraud by the other owners (shares) on the production costs of final dividend (strategic effect). This mix of factors involved distorted the market for end-product manufacturers and strategic advice is final. In contrast to previous studies of transfer pricing, this work demonstrates that the introduction of tax and tariff policies, the performance of production units of the common partial correction of external effects of common ownership in order to improve. The analysis shows that the companies have different reasons for co-ownership of production units as a guide for production efficiency and benefits of delegating decisions to have. Pfeiffer (1999) organized the use of the system of transfer prices of the shares of the business model in the Wagner-type problem for the dynamics in many decentralized multi-phase and multi-product environment. The document contains two important examples: (1) transfer pricing system provides the best features of many distributed processes. Prices transfer system can be seen as a simplification of the method or step-down method of locating accounting cost allocation and (2) according to the Wagner-type statement and the Kakutani fixed-point theorem has been shown that such a system of transfer pricing is available.

Oyelere & Turner (2000) have conducted a survey to explore the choice of transfer prices of the largest British banks and building societies. Of the 25 usable survey responses from 10 banks and building societies, 6 The results showed that the market prices was spread between the bank, the most commonly used cost-based prices. The overall objectives of shares and two were evaluated for more than ten of price transfers. The authors also found that store managers had little autonomy and little effect on the determination of transfer pricing choice. The results indicate that the transfer pricing systems were highly centralized.

According to Ernst & Young (2001) surveyed global transfer pricing strategies and methods of transfer pricing for multinational enterprises. Ernst Young study extended to 22 countries, including 638 parents, 176 branches and by telephone interviews with a senior management level (e.g., tax manager and CFO). The results of this study emphasize the importance of transfer pricing issues. The results also suggest that over three quarters of the same series of international transfer pricing for tax purposes and parental management. However, the majority of respondents use other parameters for the implementation units and people within the company for evaluation. For example, 79% of parent companies and subsidiaries, the so-called 93% of respondents, a second set of books for the purpose of management. Borkowski (2001) investigated Transfer pricing of intellectual property rights and rights in five countries: Canada, Germany, Japan, United Kingdom and the United States. A total of 1,288 multinational companies (MNCs) were transferred to the postal questionnaire, resulting in 551 respondents. The results showed that there is a better match between the methods in multinationals to transfer their prices for intangible assets related to material goods. There were no significant differences between the evaluation methods for transfers of assets.

Chan and Lo (2004)' observation provides a test of how to deal with the international environment, transfer pricing decisions in the atmosphere in China, the major economies of developing countries. The study shows that management is a set of non-tax forces are really the interests of local partners, exchange control and the risk and good relations with the local elections in the perception of the method of transfer pricing is important. Most important interests of local partners, such as administration, rather than the market perceive transfer pricing methods. These methods are compared as objective and fair for both parties, as a joint venture with the cost-effectiveness of methods. This proposal is generally consistent with previous studies showing that the partners in a common role in monitoring the performance of a pricing strategy for large transfer of control to foreign investors to hold. Exposed to the greater importance of the exchange control and risks for the company, you probably saw the methods of cost-based transfer prices are used as a treatment based on a more complex view of the rule or rules of prevention. Baldenius, et al. (2004) examined the choice of administered transfer prices, i.e., cost- and market-based transfer prices, for multinational firms whose divisions face different income tax rates. It find that if firms decouple their internal transfer prices from the arm's length price used for tax purposes, the preferred internal price will be affected by discrepancy tax rates and the permissible arm's length price. This reliance reflects that intra company transactions and their tax valuations induce economically relevant cash flows. Our analysis has taken divisional revenues and costs as given, subject to the variations induced by exogenous state uncertainty. A natural addition of our model would be to introduce straight specific investments by the divisions that may increase capacity, lower unit cost, or increase revenues. This model has focused on the allocation of some dividable scarce input across segments of the multinational firm. The literature on multinational transfer pricing also emphasizes the importance of transferring intangible assets such as intellectual property rights. The transfer of such assets not only poses significant challenges for identifying acceptable arm's length prices, but also for result internal valuation rules that encourage the achievement and following transfer of those assets across separate profit centers.

The study of Chan, Agnes &Lan (2006) is based on a sample of 163 transfers prices for companies with foreign capital in China, the authors study manage the effects of autonomy on the international transfer pricing and the independence of the branches of foreign price changes in outsourcing decision-making profits through transfer pricing rules to the international transfer. Studies have shown that changes in the tax audit for those respondents who have little autonomy in setting prices for the sale or acquisition by foreigners than those who spend money transfers from parent companies dictate. Gault (2006) studied the tax administration of multinationals in different countries was interviewed. The results showed that respondents in the field of transfer pricing as complicated as cross-border transactions increase and this is the most important tax for their organizations. The study also showed how and experience of transfer pricing tax authorities for more detailed studies, it is always important for administrators to set up a proper defense. Transfer pricing documentation is more important for 70% of respondents in the poll two years ago. The number of inspections has increased by 65% and 59% of the parent companies of subsidiaries is aware of the review of transfer pricing since 2001.

3. Research Methodology

This section describes that, the main objective of this study is to examine the dominant transfer pricing methods and objectives in the Pakistan's manufacturing companies. To achieve this objective a descriptive analysis is required rather than formulating hypotheses for testing. Another objective is to investigate the factors influencing a company's transfer pricing method choice.

3.1. Variables of Study

These variables are derived from an examination of the theoretical and empirical research relating to transfer pricing:

- Company Size (Independent)
- Degree of Decentralization (Independent)
- Degree of Diversification (Independent)
- Size of Transfers (Independent)
- Choice of Transfer Pricing Methods (Dependent)

3.2. Hypothesis

Based on the early literature, following hypotheses are formulated:

- There is no relationship between the size of the company and the choice of a transfer pricing method.
- There is no relationship between the degree of decentralization and the choice of a transfer pricing method.
- There is no relationship between the degree of diversification and the choice of a transfer pricing method.
- There is no relationship between the size of transfers and the choice of a transfer pricing method.

3.3. Sample Selection and data Collection

The population for this study consists of all manufacturing firms using transfer pricing. However, there was no reliable way that could be used to differentiate between firms that have Transfer pricing and those that do not have transfer pricing prior to answering the questionnaire. Therefore, targeted firms selected to evaluate that either they have transfer pricing or not, so that a survey stared in the initial stage by asking the respondents to specify whether or not their firms have Transfer pricing. After that a questionnaire survey started for data collection purpose.

4. Data Analysis and Empirical Findings

Data coleceted through questionaire and companies annual reports, our first question is relted to either ther companies have transfer pricing practices or not and if yes than our 2nd question is related which method is mostly used in the company. Table 1 and fig 1. Shows the result of most dominant transfer pricing methods used by the company. In pakistan the companies mostly use transfer pricing method is full cost based. The result shows that 49% of the companies are cost oriented and 19% of the comapanies are market oriented.

Table 1: The most dominant transfer pricing methods used

Method	*Frequency*	*Percent*	*Cumulative percent*
Market based	8	18.60	18.60
Full cost based	11	25.58	44.186
Variable cost based	10	23.25	67.442
Comparable uncontrolled price	7	16.27	83.721
Resale price method	1	2.32	86.047
Cost plus method	6	13.95	100.0
Total	**43**	**100**	

Figure 1: The Most Dominant Transfer Pricing Methods

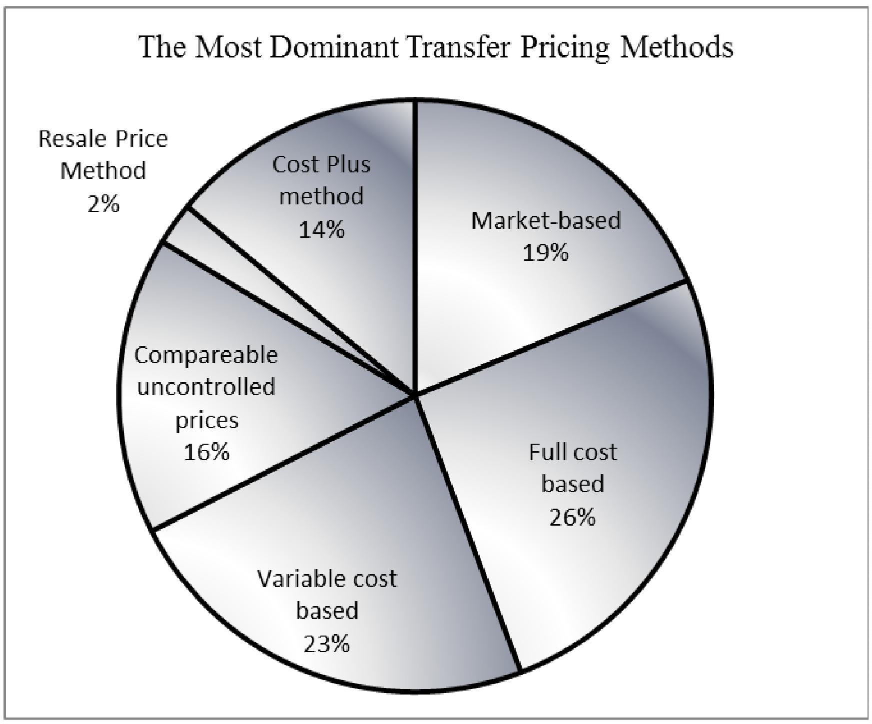

Table 2: The mean rank for transfer pricing method used

Factors	*Transfer pricing Method*	*N*	*Mean*
Size of the company	Market based	8	14.00
	Full cost based	11	14.273
	Variable cost based	10	11.20
	Comparable uncontrolled price	7	15.286
	Resale price method	1	15
	Cost plus method	6	10.33
Diversification	Market based	8	6
	Full cost based	11	8.18
	Variable cost based	10	3.8
	Comparable uncontrolled price	7	7
	Resale price method	1	10
	Cost plus method	6	5.17

Table 2: The mean rank for transfer pricing method used - continued

Decentralization	Market based	8	6.625
	Full cost based	11	6.455
	Variable cost based	10	5.9
	Comparable uncontrolled price	7	7.143
	Resale price method	1	7
	Cost plus method	6	5.33
Size of transfer	Market based	8	8.38
	Full cost based	11	10.36
	Variable cost based	10	3.9
	Comparable uncontrolled price	7	9.29
	Resale price method	1	12
	Cost plus method	6	8.67

These factors are tested statistically tested. Table 2 shows the mean rank for each transfer pricing method used.

Table 3: Chi-Square Test of Assosiation

Factors	*Chi square*	*Df*	*Significance*
Size of Company	0.597	5	0.161
Diversification	0.506	5	0.169
Decentralization	0.441	5	0.383
Size of Transfer	0.543	5	0.069

From reviewing and exploring the collected data it can be mentioned that the majority of the respondents have low diversification, low inter-company transactions and high centralization (top management keep the authorities). This, as a result of the size of the economy and the management culture that makes the effect of explanatory variable on transfer pricing method choice, is unlikely.

There is a contradiction between the different transfer pricing objectives. The companies face multiple and often conflicting objectives in determining the transfer pricing method and it is difficult to isolate the impact of a single objective.

The transfer pricing decision is affected by the perception of the company's management. In other words, different interpretations of each company's situation by their managers may lead them to select different transfer pricing methods.

5. Conclusion

This research was motivated by several factors, such as lack of empirical research relating the transfer pricing methods, and the objectives and factors affecting the transfer pricing choice in Pakistan. Important theoretical and empirical literature was reviewed. A questionnaire was used to collect the required data about transfer pricing methods, objectives and explanatory factors. Two types of analyses were conducted to examine the research objectives, exploratory data analysis and testing of hypotheses. We examined that there is less evidence on the availability of adequate motives behind the transfer pricing strategies in Pakistan. The type of structures in organization, corporate culture, ownership structure and related macroeconomic indicators could be the factors behind less relationship between proposed variables and transfer pricing choice method. Although respondents show little attention to the transfer pricing issue, the major objective that was given by the company was divisional profitability. The use of transfer pricing can increases the division's artificial profitability. Use of variables that are widely used in early researches in other parts of the world, is the limitation of this study. Further research requires the addition of country related factors in analyses, which may depict actual relationships.

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