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TRANSFER PRICING: Goals and Methods among Unlisted Companies in Kenya

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ABSTRACT

Transfer pricing is essentially an offshoot of a decentralised organisation. The firm's growth is accompanied by growing complexities in operations scope with tentacles spreading beyond the traditional job shop into several divisions, branches and even franchises. Eccles (1985) defines transfer price as the value (or price) placed on the goods, services and intangibles that are transferred within the firms, as it moves from one organizational entity (e.g., a division, a unit, a subunit, a division) to another within a corporate group. The methods of transfer pricing though with many variations are either market or cost based or negotiated. This paper was bent on adding and drawing perspectives from emerging markets and especially in regards to companies not bound by stringent regulation of their public counterparts. Therefore, the study determined whether it is the goals or internal environment that takes precedence in advising on transfer pricing method adopted. The study targeted group companies unlisted incorporated in Kenya. 47 managers holding different capacities in the group or divisions responded to a structured questionnaire. The study found out that internal transfers are significant part of business in the company surveys making transfer pricing a major decision issue among top managers. It also found cost based methods were used in all cases with full cost plus being the most common at 88.6%. hypothesis testing showed that volume of transactions and asset specificity, do not influence the transfer pricing choice. The study concludes that the management of these companies are insensitive to the ability of internal factors to influence transfer pricing decision and would rather pursue other goals rather than the ones explicit in transfer pricing. The overemphasis of cost based transfer pricing methods as used by unlisted companies means that these companies do not benefit from the roles and goals of transfer pricing like the ability to create autonomous units that could allow managers performance be assessed independently in a more challenging position a shift that is encouraged.

Keywords: Transfer Price; Internal Environment; Volume of Transfers; Asset Specificity; non listed company.

INTRODUCTION

Transfer pricing is essentially an offshoot of a decentralised organisation. The firm's growth is accompanied by growing complexities in operations scope with tentacles spreading beyond the traditional job shop into several divisions, branches and even franchises. Legally, the firm can exist as a conglomerate of several companies forming a parent and subsidiary relations. Though the proponents of the theory of the firm have consistently argued that internally, a firm can rarely maintain a plausible market structure, practice has shown that internal trade will go on the lack of a market structure notwithstanding. Trade conducted in such manner does not however benefit from a self-setting price mechanism as we know them in perfect competition. Management being cognisance of this fact will set up a price that will guide all the internal transactions as they take place.

Tang (1993), defines a transfer price as that which is appropriate to support intra firm trade in the context of a multi-national company (MNC). Given this perspective, transfer price is regarded as a vehicle to facilitate intra firm trade within a MNC. Taken further, it could mean that intra-firm trade or transfer pricing or both are not entirely necessary. Eccles (1985) has been more forthwith defining transfer price as the value (or price) placed on the goods, services and intangibles that are transferred within the firms, as it moves from one organizational entity (e.g., a division, a unit, a subunit, a division) to another within a corporate group. In this perspective, we are allowed to state that transfer pricing does bear recognition even when intra-firm trade occurs within national borders or within seemingly insignificant units within an organisation as long as the organisation structure allows for such differentiation.
Transfer pricing applies across a varied range of transfer such as finished products, tangible product components for example processors in a computer assembly shop or complete packaged product for example a radio selling to a newspaper mention slots for advertisements within the same media house. In some mundane circumstances, units may transfer services which form their core activities for example, the finance department may charge it services to other departments using a transfer price. Spicer (1988) has referred to three forms of transfers classified according to the degree of customisation or idiosyncratic. The transfers may be highly

idiosyncratic meaning that they may only fit the particular enterprise, or neutrally customised or of low standard. It follows that high idiosyncratic transfers will require more specific, high cost investment to get through. At the same time, high idiosyncrasy calls for more co-operation between the divisions conduction the transfer transaction.

Horngren, et al (2003) have stated that firms use transfer pricing to pursue four key goals, thus goal congruence, management effort, sub unit performance evaluation as well as the sub units autonomy. If the sub unit is allowed to pursue its own goals, this may be done at the expense of the entire firm hence sub-optimal achievement of goals. Whether a firm is able to attain these goals or will be determined by other factors internal or external to the firm as we illustrate in this study.

The prerogative for decision making only exists where there are alternatives to choose from. The transfer pricing scenario is not any different. Though there exist several bases from which transfer prices are determined, Feinschreiber (2004) has concluded that whatever the transfer pricing method management may apply is actually a variations of either actual full cost, standard full cost, or Market-based transfer price. This paper in discussing determinants of transfer pricing will consider these three methods and the various variations which have been built through practice and extant empirical evidence.

We have mentioned before that the choice of transfer price is determined by the goal the firm wants to achieve. Different transfer pricing methods have been found to interact differently towards achieving the four different goals. For example according to Li and Ferreira (2007), the transfer pricing method applied will depend on the level of autonomy which firms management seeks to bestow on the sub-units. Cost based prices and methods will be used when low levels of sub-unit autonomy are being sought. As the level increases so does the firm migrate to adjusted external market price and further to negotiated internal market price as a way of assuring high subunit autonomy. This phenomenon is illustrated in table 1 below.

The extent to which these goals are achieved is dependent on organisational factors such as internal management rules and the methods of transfer pricing which top management has elected to adopt. This study was bent on determining such interaction within the framework of an unlisted company. Unlisted companies as by incorporation private limited companies which in a majority of the cases are family owned businesses. We can therefore postulate that unlisted companies will desire to pursue corporate goals which do not threaten the very fabric that underpins their success.

Indeed, according Olson et al., (2003) to it is generally accepted that these firms aim to achieve a combination of financial and nonfinancial goals that are sometimes variant from conventional firms. This has been attributed to findings that point to significant variations in perceptions of family firm stakeholders regarding even the most fundamental issues as underscored by, Poza et al., (1997) and Sharma, (1997). This goes to say that unlisted companies that practice transfer pricing may do so in a manner that is entirely different from conventional practice.

RESEARCH PROBLEM

Extant literature shows the kind of transfer pricing methods which have been adopted in various countries especially in the developed world. Industry wise, Oyele and Turner (2000) found out that market based transfer prices were used by 57% of banks in the UK. Cost based prices were used by 37% while the negotiated prices were paltry used at 7%. Similar results have been found in other regions and industries (Tang, 1993; Li 2005).The decision to select and adopt a certain transfer price mechanism solely rest on the enterprise that is either involved in the buying or selling. In some cases, with sanctions from the head office or parent company in case of a group structure. The firm may be influenced by several factors both internal and external environmental factors. For instance, the desire to comply with tax laws and regulations was ranked as the most important external factor in setting transfer prices for MNCs operating in New Zealand (Li, 2005). Similar findings are observed by Al-Eryani, et al (1990).

The studies highlighted above articulate transfer pricing practices in a developed regulatory environment where corporate reporting is advanced. They also represent findings in respect to public companies listed in various exchanges. This paper was bent on adding and drawing perspectives from emerging markets and especially in regards to companies not bound by stringent regulation of their public counterparts. This means that managers in such environments have greater leverage in choosing the transfer practise method to adopt as they are not bound by any reporting or disclosure requirement or scrutiny. Therefore, the study determined whether it is the goals or internal environment that takes precedence in advising on transfer pricing method adopted.

REVIEW OF LITERATURE

Establishing transfer prices is complex because a transfer pricing system is usually required to achieve many conflicting objectives. Numerous articles have been written over the past 50 years; therefore, precedence is given to the most recent literature, to the empirical or survey studies, and to the literature that has become established as part of conventional wisdom. Also, the studies conducted by professional companies (e.g., KPMG, Ernst and Young) to investigate the TP issue in a large number of countries, Kenya or regional countries were not included.

Chan, Agnes and Lan (2006) have based on a sample of 163 transfer pricing audits on foreign investment enterprises in China, the authors examined the impact of managerial autonomy on an international transfer pricing, and whether foreign subsidiaries autonomy in making pricing and sourcing decisions on intra-firm transfers affect their profit shifting through international transfer pricing. The study found that tax audit adjustments for respondents that have autonomy in setting transfer prices or sourcing from outsiders are smaller than those that have their transfer transactions dictated by parent companies. Gault (2006) carried as survey on tax directors in multinational companies across several countries. Findings have shown that the respondents considered transfer pricing as becoming more complex as cross-border transactions increase, and that it is the most important tax issue facing their organizations. The survey also found how, as transfer pricing audits become more detailed and tax authorities become more experienced, it becomes more important for tax directors to have adequate defences. Transfer pricing documentation was found to be more important for 70% of respondents in the survey than it was two years ago. The number of audits has also increased, 65% of parent companies and 59% of subsidiaries stating that they have experienced an examination of their transfer prices since 2001.

In another study, Ki Ho and Lau (2005) examined international transfer pricing (ITP) practices of U.S. multinationals (MNCs) in the People's Republic of China (PRC) and the United Kingdom (UK) on comparative basis. They examined the U.S. multinationals' practices towards ITP for transactions with their affiliates in these countries and provide empirical evidence on the methods of ITP practices. The sample used in this study consisted of 463 U.S. MNCs that were drawn from the 500 largest corporations in 2000. Empirical evidence suggests that market price and full cost plus are the most commonly used ITP methods. The results of this study also reveal that there are no significant differences in the perceived frequency of use of various ITP methods by U.S. MNCs for transactions with their affiliates in the PRC and the UK.

Abdalla and Ekeledo (2005) surveyed 178 global companies sample of American global companies in the steel industry is used to ascertain whether the relative performance of managers of foreign subsidiaries of global companies reflects the objective and operational performance measures of their companies through using intra company pricing (Transfer Pricing).

The study has found that the relative managerial performance of subsidiary managers could be measured and compared with a high degree of objectivity, which means that the global companies should consider all environmental factors in their performance evaluation systems. A model for evaluating the performance of foreign subsidiary managers combined with transfer pricing system is provided in this study.

Borkowski (2001) investigated the transfer pricing and legislation of intangible property in five countries: Canada, Germany, Japan, the UK and the US. A total of 1288 Multinational Companies (MNCs) were approached by postal questionnaire, yielding 551 respondents. 159 of these had cross-border transfers of intangible property. The results of this study revealed that there is greater agreement among MNCs on their transfer pricing methods for intangible property compared with tangible goods. Also, there was no significant difference in the methods used to value intangible property for cross-border intangible transfers.

KPMG (2001) after two years of applying the new transfer pricing regime in the UK that required the adjustment of intra-firm pricing to the Arm's Length Principle for tax purposes, KPMG considered it was timely to ask companies about this regime. KPMG conducted a survey of 150 companies to look at the impact of the UK transfer pricing regime on the operations and practices of MNCs that trade in the UK. The results of this survey indicated that the respondents considered that transfer pricing continues to be the number one international tax issue, and it will continue to be the most important issue for the next three years. The application of the new transfer pricing regime affected the tax planning strategy of 63% of respondents. However, after two years of applying the new regime in the UK, the majority of the respondents did not understand the regime in depth.Interdisciplinary Journal of Research in Business

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The Ernst and Young (2002) global transfer pricing survey was a comprehensive investigation of transfer pricing practices and strategies among MNCs. Ernst and Young expanded the survey to 22 countries; a total of 638 parent company and 176 subsidiary interviews were conducted through telephone with high senior officials (e.g. tax managers and financial directors). The results of this survey emphasized the importance of the transfer pricing issue. The results also indicated that over three-quarters of MNCs parents used the same set of transfer prices for both tax and management purposes. However, the majority of respondents used other metrics to judge the performance of units and individuals within the company. For example, 79% of parent companies and 93% of the subsidiaries respondents have a so-called "second set of books" for management purposes. Also, the majority of the companies based their performance measures on pre-tax financial results for units and managers. Oyelere and Turner (2000) conducted a survey to explore the transfer pricing choices of the largest UK-based banks and building societies. Out of 25 mailed questionnaires, there were usable responses from 10 banks and 6 building societies. The results indicated that market based pricing was predominant among the banks, whereas building societies mostly used cost-based pricing methods. The achievement of overall corporate goals and fairness were the two highest ranked of the ten transfer pricing objectives. Branch autonomy received the lowest ranking. The authors also reported that the branch managers had little autonomy and had little influence in determining the transfer pricing choice. The findings indicated that the transfer pricing systems were highly centralised.

The primary research question in McGaughey (1997) study was; what are the important factors that influence the transfer pricing systems in selected industries? He investigated the transfer pricing practices of selected chemical and electronic American companies with domestic and international businesses, with the response received from 247 MNCs. The study found that the use of transfer pricing was more widespread among the chemical firms than the electronic firms and that there were no significant differences between the orientations of the transfer pricing methods used by the chemical and electronic firms. According to the result of rating and ranking the importance of situational factors, the findings showed that the most important factors influencing the choice of transfer prices for two industries were overall profit, restrictions imposed by foreign countries and the competitive position of the foreign division.

Ernst and Young (1999) surveyed MNCs about a variety of international tax transfer pricing issues. The respondents were 393 multinational parent companies and 76 subsidiaries of foreign-owned parents in 12 primary survey countries. The results indicated that transfer pricing remains an important issue facing MNCs around the world. Over the next two years the respondents considered that transfer pricing will be the biggest international issue. Transaction-based methods, such as the comparable uncontrolled price, resale price, and cost plus methods were the most commonly used methods in this survey.

Cravens and Shearon (1996) study 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.

Significant also from the literature review is that much thought and effort has been given to the problem of international transfer pricing. Domestic transfer pricing has a different mindset, objectives and challenges. The experience of international transfer pricing while useful in building the blocks of transfer pricing understanding may not suffice as a platform for dealing with domestic issues. This paper therefore attempts to address these gaps.

CONCEPTUAL FRAMEWORK

The interaction between variables for the study is expressed in this section. The study's dependent variable was transfer pricing method which was available either based on the market

price, cost or negotiated. The predictor variables accordingly in relation to the study objectives and theoretical framework discussed above were volume of transfers to operationalised nature of transfers, asset specificity and vertical integration operationalised as diversity. Asset specificity according to Williamson (1986) can be derived from six sources thus location specificity, physical asset specificity, human asset, investment and brand specificity. This study considered all
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but temporary specificity. The relationship between the variables was determined by testing the hypotheses marked H1 and H2 in figure 1 below.

RESEARCH METHODOLOGY

The study targeted group companies unlisted incorporated in Kenya. It has been inferred in the study that most of these companies are by their nature family businesses which are generally removed from public domain except for their trading activities. The study therefore identified one parent company that was willing to respond to the survey from which other parent companies were snowballed. The sampling yielded six (6) groups and a total of 22 divisions or companies. 47 managers holding different capacities in the group or divisions responded to a structured questionnaire. This instrument was used to elicit responses on transfer pricing methods and the effect of the internal environment. The variables used are described in table 2 below as well as their measurement. The relationship between internal environment variables (independent variables): volume of transfers and asset specificity and dependent variable- transfer pricing method adopted was determined by testing the following research hypothesis:

H1: transfer pricing method adopted is independent of volume of transfers.
H2: transfer pricing method adopted is independent of asset specificity.

The statistical test used to examine these hypotheses was Kruskal-Wallis because according to Bryman and Cramer, (2005) it can be used for the categorical/nominal variable and forum related type of data. Transfer pricing methods in this study is categorical, since the respondents companies were expected to use one of five transfer pricing methods. The test is also non-parametric, which means it forgoes the traditional assumptions that the underlying population is normal. Its usefulness in also emphasised by Kendall and Gibbons, (1990); Field, (2001) who opine that it is apt when the sample size is very low and the distribution of the population is not known. In our case the sample size was 6 companies.

RESEARCH FINDINGS

Descriptive survey

The items of the descriptive survey about the sample companies include the designation of respondents, the turnover of the firm, the proportion of transfers in relation to annual turnover, the involvement of respondents in the transfer pricing process, and the transfer pricing method used by the firm as depicted in Table 3. Among these data, the designated finance managers who responded is greatest at 52.9%. Production managers who responded were 23.5% followed by divisional managers at 17.3%. The response of marketing managers is least at 5.8%. The mean annual turnover of the firm involved in internal transfers is shilling 592 million while the mean proportion of internal transfers over turnover is 69.3%. This shows that internal transfers are significant part of business in the company surveys making transfer pricing a major decision issue among top managers.

Managers involvement in the process of setting transfer prices is important because it determine the extent to which implementation of the various attendant objectives is achieved. 25.1% of the managers indicated that they engaged in reviewing the transfer price method in view of revising it. Those that prepared cost statement to guide transfer price setting were 88.2%. Some managers did indeed attend the meeting whose resolution was the fixing of the transfer pricing as indicated at 41.1%, while 35.3% just received communication from the board of directors about the said resolution. However, 5.8% of the managers stated that no review had taken place during their tenure. This point out to the fact that mandated transfer pricing methods may take a considerable time before they are reviewed.

Of importance though is the distribution of transfer pricing methods among companies surveyed. Cost based methods were used in all cases with full cost plus being the most common at 88.6%. Variable cost method as used by 64.7% of the firms, while 36.9% of the firms used full cost plus margin method. The results indicate that all firms interviewed use cost based transfer pricing methods. The popularity of full cost and variable cost methods point to the extent to which those setting prices will allow decision making to be done by divisional managers since the interest is all about cost recovery.

Hypothesis testing

Two hypotheses as expressed earlier in the conceptual framework were tested in order to determine the effect of the internal environment on transfer pricing in the firm. Two variables were used to represent internal environment thus volume of transaction and asset specificity. These factors are tested statistically be using Interdisciplinary Journal of Research in Business
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Kruskal-Wallis test. Tables 4 and 5 show the mean rank for each transfer pricing method used, the Chi-square level and its significance level corrected for rank ties respectively.

The results of Kruskal-Wallis Statistical tests conducted are shown in table 5 above. At 5% significance level, the p values deduced are for the variables are all greater. Accordingly, the null hypothesis is rejected thus the research hypotheses stated earlier were accepted, which means that of the two variables: volume of transactions; asset specificity, do not influence the transfer pricing choice.

CONCLUSIONS AND RECOMMENDATIONS

This research was motivated by several factors, such as the lack of empirical research relating the transfer pricing methods, goals and factors affecting the transfer pricing choice in Kenya among unlisted companies. The study concludes that cost based methods are in use predominantly. The study also concludes that managers are not sufficiently involved in setting transfer prices which means it remains a prerogative of the board.

The study agrees with the propositions by Li and Ferreira (2007) that cost based methods are to be used in firms that express low sub unit autonomy. In line with the findings that the internal factors and asset specificity do not influence transfer pricing method chosen, the study concludes that the management of these companies are insensitive to the ability of internal factors to influence transfer pricing decision and would rather pursue other goals rather than the ones explicit in transfer pricing. The study also concludes that transfer pricing may be achieving goal congruence but it attainment of managers effort and sub unit evaluation remains to be seen. This conclusion is supported by some of the prior studies, such as Cravens and Shearon (1996); Borkowski (1990); McGhaughey (1997) and Chan et al (2006).

The overemphasis of cost based transfer pricing methods as used by unlisted companies means that these companies do not benefit from the roles and goals of transfer pricing like the ability to create autonomous units that could allow managers performance be assessed independently in a more challenging position a shift that is encouraged.

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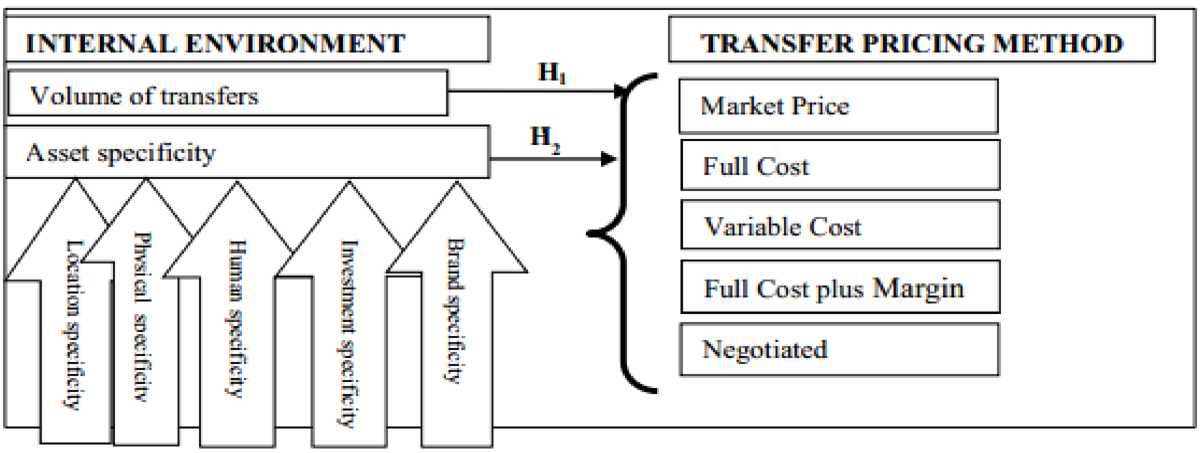

Figure 1: Conceptual Framework

Table 1: Typology of Transfer Pricing

Low Subunit Autonomy	**Moderate Subunit Autonomy**	**High Subunit Autonomy**
Cost based price	Adjusted external- market price	Negotiated/ internal market price
information on supplier cost is referred to while setting transfer prices	Prices on the external market serve as the referent for determining the values of internal transfers.	Managers of the trading profit centres establish a price that is acceptable to both the seller and the buyer before the exchange can be consummated.
e.g., actual full production cost; standard production cost; full production cost plus mark up; etc.	e.g., market prices less a discount; best price to an outsider during a specific period; negotiated price with listed price range; etc.	e.g., negotiated prices between subunits, bidding.

Source: *Li and Ferreira (2007)*

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Table 2: Variable description and measurement

Variable	**Description**	**Measurement**
Transfer pricing	Transfer price method adopted by firm	Dummy variable (1= cost based TP; 0 if otherwise)
Volume of transfers	Proportion of transfers in a financial year over total turnover	Transfer turnover/total turnover and Count data(5 point Likert)
Asset specificity	i. Physical asset ii. Location specificity iii. Human asset specificity iv. Brand name capital v. Specific investment (e.g research and development)	Count data (5 point Likert)

Table 3: Descriptive Statistics

Description n=47	Frequency	Mean
Designation of respondent		
Division manager	17.3%	n/a
Finance manager	52.9%	n/a
Marketing manager	5.8%	n/a
Production manager	23.5%	n/a
Annual turnover	n/a	592m
Proportion of turnover transferred internally	n/a	69.3%
Transfer pricing process		
Engaged in reviewing the transfer price method in view of revising it.	25.1%	n/a
Prepared cost statement to guide transfer price setting	88.2%	n/a
Attended high level meeting to set price	41.1%	n/a
Received communication from board setting price	35.3%	n/a
No review has taken place during my tenure	5.8%	n/a
Transfer pricing method		
Full cost	88.6%	n/a
Variable cost	64.7%	n/a
Full cost plus margin	36.9%	n/a

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Table 4: The mean rank for Transfer Pricing methods used

Variable		TP method	n	Mean
Volume of transfers		Full cost	17	10.3
		Variable cost	26	14.0
		Full cost plus margin	4	13.4
Asset specificity	Location	Full cost	21	8.3
		Variable cost	17	14.6
		Full cost plus margin	9	7.8
	Physical asset	Full cost	22	11.2
		Variable cost	20	13.1
		Full cost plus margin	5	10.3
	Human asset	Full cost	24	9.3
		Variable cost	11	10.5
		Full cost plus margin	12	13.1
	Investment	Full cost	27	14.7
		Variable cost	10	10.9
		Full cost plus margin	10	13.6
	Brand	Full cost	15	16.1
		Variable cost	16	15.5
		Full cost plus margin	16	10.2

Table 5: Kruskal-Wallis Statistical tests

	Volume of transfers	**Asset specificity**				
		Location	**Physical asset**	**Human asset**	**Investment**	**Brand**
Chi square	4.664	3.157	5.551	7.10	6.91	5.03
df	4	4	4	4	4	4
p value	*0.031	*0.023	*0.018	*0.031	*0.042	*0.047

*α=0.05