Journal of Accounting Literature 31 (2013) 31–48

Contents lists available at SciVerse ScienceDirect

Journal of Accounting Literature

journal homepage: www.elsevier.com/locate/acclit

Multinational transfer pricing: A transaction cost and resource based view

Mark Cecchini *, Robert Leitch, Caroline Strobel

University of South Carolina, United States

ARTICLE INFO

Keywords:
Transfer pricing
Multinational enterprise
Resource based view
Transaction cost economics

ABSTRACT

Transfer pricing stands at the heart of a MNE management control system. We review the theories of TCE and RBV and develop antecedents and consequences of transfer prices based on these theories. We propose viewing transfer pricing decisions through a TCE and RBV value chain framework. We review a sample of transfer pricing literature based on this theoretical perspective and show how it fits within our framework. Our framework suggests that setting transfer pricing policy is indeed a complex problem that includes many factors and has many consequences, some of which may be at odds with each other. We give some suggestions for future research based on this framework.

1. Introduction

Multinational enterprises (MNEs), by their very nature, have advantages and disadvantages. A major advantage (and thus major motivation) is that operating in many countries provides the opportunity to exploit structural market imperfections for competitive advantage. However, this potential advantage can only be realized if the entities that comprise the MNE are well-coordinated. In cases where coordination is not achieved, a MNE can become unwieldy, providing limited advantage. Transfer pricing policy can help a MNE take advantage of complex international market imperfections while managing costs and risks.

A process which is critical to determining the success of a MNE is its value chain, both internal and external. Managing a value chain involves a number of things, the first of which is the organization of

* Corresponding author at: Mark Cecchini, School of Accounting, Moore School of Business, University of South Carolina, Columbia, SC 29208, United States. Tel.: +1 803 777 6643; fax: +1 803 777 0712.
E-mail address: Cecchini@moore.sc.edu (M. Cecchini).

0737-4607/$ – see front matter
http://dx.doi.org/10.1016/j.acclit.2013.06.001

entities, whether they are divisions of the same organization, or are separate organizations operating together as a joint venture. These entities may be segmented by country, by legal entity, or by product line. The goal of the value chain is to maximize their joint value. In a vertically integrated organization consisting of a number of decentralized autonomous entities, an important coordination procedure is the transfer price charged for goods and services transferred from division to division (entity). Transfer pricing refers to the prices placed on goods, services, and intangibles as they move between economic entities of a MNE. Transfer pricing policy is particularly difficult for a MNE because they need to not only determine a transfer price that is in the best interest of the organization and the individual entities in the value chain, but also one that will satisfy the regulatory requirements of host countries where foreign divisions are located. This problem is compounded by the decision of where to locate worldwide resources in order to exploit market imperfections and maximize the organization's value chain. These decisions will be determined by the nature of the product created, market structure, environmental factors including tax policies, relative power and dependence among entities, governance procedures, socioeconomic and geopolitical risks, transaction risk, and the nature of the resources used to create value. These issues make transfer pricing one of the most important problems facing MNEs today, as Ernst and Young (2007) found in a survey of 850 MNEs.

To assess the state of research involving MNE transfer pricing, we consider two theories regarding boundary procedures among entities in a value chain, and provide a framework for relating these theories to transfer pricing issues and extant literature. These two value (supply) chain boundary theories are transaction cost economics (TCE) and the resource based view (RBV) of an organization. Traditionally, these theories have been applied to inter-organizational value chains (e.g., Anderson & Dekker, 2009); we apply them intra-organizationally to provide a framework to study and review MNE transfer pricing issues and literature. We further suggest a way to move forward to help MNEs manage their organizational boundaries by better understanding the complex set of objectives and constraints engendered in the transfer pricing decision, such as those outlined in Leitch and Barrett (1992), Smith (2002b), Baldenius, Melumad, and Reichelstein (2004), Chan, Lo, and Mo (2006), Gox and Schiller (2007), Villegas and Ouenniche (2008) and Doupnik and Perera (2009). We suggest a framework based on TCE and RBV theories to assess the antecedents and consequences of MNE transfer prices.

In general, TCE focuses on minimizing risks associated with transaction costs through cooperation among entities. In particular, the main risks considered are those associated with the exchange of goods and services among entities (sometimes called performance risk), and concerns of opportunism on the part of some entities (sometimes called relational risks) (e.g., Anderson & Dekker, 2009; Das & Teng, 2001; Williamson, 1985). In contrast, the resource based view (RBV) of the firm focuses on the strategic benefits of cooperation among entities (Anderson & Dekker, 2009). An organization's ability to accumulate and strategically deploy resources can lead to competitive advantage (Das & Teng, 2000). TCE and RBV are often considered in supply chain literature. We view a MNE as a closely held supply chain, borne out of strategic or tactical necessity to generate value. MNEs often arise from the need to vertically integrate operations. Therefore, we can view this type of organization as a value chain, where transfer prices provide economic, contractual, managerial, and relational governance policies, which are used to achieve this value generating objective.

MNE transfer pricing decisions can involve multiple objectives, such as: the maximization of global profit, or its counterpart, the minimization of global taxes; the maximization or equitable division of entity profits to reward and motivate entity managers (Baldenius et al., 2004; Chan et al., 2006; Gox & Schiller, 2007; Smith, 2002b; Villegas & Ouenniche, 2008)[1]; preservation of entity autonomy; reduction of risks related to economic, currency, and geopolitical concerns; and minimization of government intervention and compliance with operational constraints (e.g., Doupnik & Perera, 2009; Leitch & Barrett, 1992; Villegas & Ouenniche, 2008). MNE entities are interrelated along legal lines as well as potentially product, activity, resource, and business process lines. As a result of these interrelationships, the nature of the transactions between entities may be very complex. This complexity requires the consideration of additional relationships beyond the traditional dyadic relationships considered in much of the transfer pricing literature and regulation.

[1] This can be stated in numerous ways such as the efficient allocation of resources and the incentives for efficient trade.