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Management control in the transfer pricing tax compliant multinational enterprise

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Abstract

This paper studies the impact of transfer pricing tax compliance on management control system (MCS) design and use within one multinational enterprise (MNE) which employed the same transfer prices for tax compliance and internal management purposes. Our analysis shows immediate effects of tax compliance on the design of organising controls with subsequent effects on planning, evaluating and rewarding controls which reveal a more coercive use of the MCS overall. We argue that modifications to the MCS cannot be understood without an appreciation of the MNEs' fiscal transfer pricing compliance process.

Introduction

This study addresses the influence of transfer pricing tax compliance on the design and use of management control systems (MCSs) in multinational enterprises (MNEs) using one set of transfer pricing books. The domestic management accounting and control literature stresses the role of transfer prices as MCS instruments that differentiate and integrate the actions of parts of the organisation and impact on performance evaluation (Colbert & Spicer, 1995; Eccles, 1983, 1985; Gosh, 2000; Luft & Libby, 1997; Spicer, 1988; Swieringa & Waterhouse, 1982; Van der Meer-Kooistra, 1994; Watson & Baumler, 1975). Cross-border transfer pricing in MNEs[1] have traditionally received a place in other streams of the

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[1] In a multinational environment, the transfer pricing policy contributes to a large variety of goals, including profit maximisation, cash flow, sales and marketing goals; minimising taxes, duties and tariffs; and achieving socio-political goals related to financial restrictions, currency fluctuations and host country relations (Dunning, 1980; Leitch & Barrett, 1992).

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literature. Tax law studies discuss national tax regimes, tax compliance requirements, and the optimal transfer pricing method from a fiscal point of view (Douvier, 2005; Kroppen & Eigelshoven, 1998; Levey, Brandman, & Miesel, 2001; Swenson, 2001; Van Mens & Porquet, 2001). Tax accounting studies investigate the degree to which national tax rate differentials lead to transfer pricing manipulation and income shifting (Grubert & Mutti, 1991; Gupta & Mills, 2002; Halpirin & Srinidhi, 1987, 1991; Harris, 1993; Harris, Kriebel, & Raviv, 1982; Jacob, 1996; Jensen, 1986; Klassen, Lang, & Wolfson, 1993). The contingency literature provides an alternative perspective by identifying the objectives of a company's (international) transfer pricing policy and the organisational and environmental determinants – such as the tax regulations – of its transfer pricing method (Borkowski, 1992a, 1992b, 1996, 1997; Cravens & Shearon, 1996; Cravens, 1997; Emmanuel & Mehafdi, 1994; Tang, 1979).

We aim at refining the general statement from the contingency literature that 'international tax rules affect the choice of the transfer pricing method' by investigating the potential impact of tax compliance on the design and use of the MCS within MNEs. Tax compliance has recently gained in importance given that fiscal authorities worldwide have strengthened their transfer pricing tax rules. While the extant tax law and tax accounting literatures focus on fiscal optimisation, a number of recent analytic studies calculate the transfer prices that reconcile managerial and tax objectives under certain static circumstances (Baldenius, Melumad, & Reichelstein, 2004; Halpirin & Srinidhi, 1991; Hyde, 2002; Hyde & Choe, 2005; Narayanan & Smith, 2000). In contrast, we use a case study to investigate the process over time when searching to answer our central research question: *What is the impact of the steps taken to comply with international transfer pricing regulations on the design and use of the MCS in an MNE using one set of transfer prices*?

The MNE under study chose to adopt tax compliant transfer pricing by using the same set of books for both MCS and tax purposes, an assumption of most analytic articles (Halpirin & Srinidhi, 1991; Sansing, 1999; Smith, 2002a). Some recent studies (Baldenius et al., 2004; Hyde & Choe, 2005; Smith, 2002b), however, model two distinct transfer prices, one to serve incentive purposes and the other to serve tax purposes. Still, MNEs commonly use the same set of books, 'both for simplicity and in order to avoid the possibility that multiple transfer prices become evidence in any disputes with the tax authorities' (Baldenius et al., 2004, p. 592; Durst, 2002; Ernst & Young, 2001, 2003, 2005). Consultants advise MNEs to implement one set of books to demonstrate to the tax authorities that transfer pricing is justified by internal, rather than purely tax-driven motives (Ernst & Young, 2001, 2003). While the analytic literature regards tax compliance as a fact, the current study on MCS design and use explicitly examines the process of gaining tax compliance: for one successful MNE the redesign of the transfer pricing system to ensure fiscal compliance and its impact on the MCS are investigated over the period 1993–2001. We use Eccles (1985) work to describe the tax compliance process, while Chow, Shields and Wu's (1999) framework guides the analysis of MCS design, and Adler and Borys (1996) and Ahrens and Chapman's (2004) concepts of 'enabling' versus 'coercive' control systems guide the analysis of MCS use. The data are partly historical, based on archival documents and recollections by managers, and partly longitudinal, with one researcher having been present in the case company between 1999 and 2002.

We find that our company's tax compliant transfer pricing policy permeates all levels of the organisation and influences elements of its MCS. Analytic generalisation suggests that tax compliance is an additional contingent variable when seeking to understand MCS design and use in MNEs. Our study therefore contributes to the contingency school of accounting research investigating how the role of management accounting is influenced by environmental factors (Abernethy & Lillis, 1995; Ahrens & Chapman, 2004; Chenhall, 2003). We also aim at responding to the call for theoretical contributions that explain how transfer pricing processes within the MCS are actually managed (Colbert & Spicer, 1995; Spicer, 1988) and delve into the deeper internal consequences of transfer pricing in MNEs (Cravens &