Pergamon

The International Journal of Accounting
39 (2004) 93–110

The International Journal of Accounting

The influence of management perception of environmental variables on the choice of international transfer-pricing methods

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Abstract

In this paper, we provide an empirical study of the association between the management's perception of the importance of environmental variables and their choice of international transfer-pricing methods in the context of a developing economy. Given the sizable investment flowing to developing countries and the amount of economic exchange that occurs through foreign investment in these countries, we believe this is a significant issue. For this study, we collected the data from field interviews with the management of large foreign investment enterprises (FIEs) in China. These FIEs include mainly investors from the United States, Japan, and Europe. Our evidence indicates that the more important management perceives the interests of local partners and the maintenance of a good relationship with host government to be, the more likely that the FIE will use a market-based transfer-pricing method. On the other hand, the more important the management perceives foreign exchange controls in transfer-pricing decisions, the more likely the FIE will choose a cost-based method. Finally, there is a moderate agreement between U.S. and non-U.S. FIEs on the relative importance of the environmental variables.

Keywords: Environmental variables; Foreign investors; International transfer-pricing; Major developing economy

1. Introduction

In this paper, we empirically investigate how the management's perception of environmental variables influences their choice of international transfer-pricing methods. The study is based on data collected from field interviews with the management of large

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0020-7063/$30.00
doi:10.1016/j.intacc.2003.12.004

foreign investment enterprises (FIEs), which include Sino-foreign joint ventures and wholly foreign-owned companies in China. As the world economy becomes more globalized, transfer-pricing has become increasingly challenging to multinational corporations (MNCs) in planning and implementing their global operations. Strategically selected transfer prices can maximize global tax savings, minimize operating risks, and circumvent restrictions imposed by host governments. A survey of accounting educators by Sands and Pragasam (1997) found that transfer-pricing was ranked as one of the most important topics in international accounting. However, there are few empirical studies that assess how the management's perceptions of environmental variables influence their selection of transfer-pricing methods in a developing-economy context.

We choose to look at transfer-pricing in China because of China's increasing importance in the world economy and the significant volume of interfirm trade by MNCs with their affiliated companies in China. In the early 1990s, China witnessed a sharp rise in the inflow of direct foreign investment. China's entrance to the World Trade Organization has further accelerated the trend of inflows of foreign investment (*Business Week*, 1999, November 29). Foreign direct investment in China reached US$50 billion in 2002, and China overtook the United States as the largest recipient of foreign direct investment in 2002 (*SCMP*, 2003, February 15). China's foreign trade has also grown substantially in the past decade, and China has been ranked as a top 10 trading nation in the world since 1999 (United Nations, 2002). FIEs play an increasingly important role in China's foreign trade. For example, total imports and exports by FIEs accounted for, respectively, 54% and 52% of the country's total imports and exports in 2002 (52% and 50%, respectively, in 2001; MOC, 2003; SSB, 2002). As will be explained later, these trades include a large volume of transactions with their overseas affiliated companies. Although China is unique, due to its rapid economic growth rate and large population, it is essentially a developing country and is classified as such by the International Monetary Fund (2003). The findings of this study, therefore, should serve as a useful reference for other developing economies by enhancing their understanding of MNCs' transfer-pricing behaviors.

Prior studies on the important environmental variables that MNCs use to make their transfer-pricing decisions have focused on developed countries. This study extends prior studies by examining how the management's perception of the relative importance of environmental variables affects their choice of transfer-pricing methods in China, which is a developing economy. Seven environmental variables important to operations in developing countries are examined in the context of the business environment in China. These variables are (1) difference in income tax rates, (2) minimization of custom duties, (3) the interests of local partners, (4) foreign exchange control and risks, (5) restrictions of profit repatriation, (6) risks of expropriation and nationalization, and (7) a good relationship with the host government.

The analysis of our data reveals that management's perception of three environmental variables, namely, the interests of local partners, foreign exchange control, and the maintenance of a good relationship with the host government, are significant to discriminate FIEs' choice of transfer-pricing methods. The more important the management perceives the interests of local partners and the maintenance of a good relationship with the host government to be, the more likely that an FIE will use a market-based method. The more important the management perceives foreign exchange controls to be, the more likely