Overhead cost allocation changes in a transfer pricing tax compliant multinational enterprise

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ABSTRACT

This paper addresses how overhead cost allocation system design in multinational enterprises (MNEs) is affected by transfer pricing tax regulation. Using a case study research strategy we find that the implementation of a transfer pricing tax compliance strategy gives rise to a number of changes to the overhead cost allocation system design. Findings suggest that a contingent relationship exists between overhead cost allocation and transfer pricing tax compliance. We argue that when seeking to understand and explain MNEs’ overhead cost allocation system design for intra-company services, the MNEs’ response to its tax regulatory environment is a significant explanatory variable.

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1. Introduction

Recent studies (Cools et al., 2008; Deloitte, 2007; Oosterhoff, 2006; Wunder, 2009) indicate that international transfer pricing is one of the primary topics of tax management in multinational enterprises (MNEs). The main reason is that tax authorities worldwide have increased their focus on whether MNE intra-company transfer pricing is comparable to the prices that independent parties would have chosen in similar circumstances. This is particularly the case for intra-company services and overhead cost allocations, which currently seem to be the transaction type most often reviewed by tax authorities (Ernst & Young, 2007). However, studies exploring MNEs’ reactions to the increasing pressure on overhead cost allocation practices from external stakeholders, i.e. regulators and tax authorities, are at present limited. Consequently, this paper addresses how the implementation of a transfer pricing tax compliance strategy impacts on the overhead cost allocation system design in an MNE that applies the same accounting system for managerial and tax purposes. Using a case study research strategy, we carry out a dynamic analysis of the change process to overhead cost allocations in one MNE where transfer pricing tax compliance evolves from being a topic receiving limited managerial attention to occupying a position where it becomes an explicit tax management strategy.

Our paper contributes to the contingency school of accounting research that investigates how cost accounting is impacted in practice by the contextual factors of an organization (e.g. Borkowski, 1990, 1992, 1996, 1997; Chenhall, 2003, 2007; Cools et al., 2008; see also Jones, 1985; Lawrence and Lorsch, 1967; Otley, 1980; Schweikart, 1985; Tiessen and Waterhouse, 1983). Specifically, we aim to respond to calls for in-depth case studies of transfer pricing practices (Cools, 2003, 2006; Cools et al., 2008; Elliott and Emmanuel, 2000a; Emmanuel and Mehafi, 1994; Spicer, 1988), including the way MNEs approach their transfer pricing process. Transfer pricing has been a research objective for decades (e.g. Abdel-khalik and Lusk, 1974; Grabski, 1985; Hirschleifer, 1956; McAulay and Tomkins, 1992). However, in-depth studies that improve our ability to understand and explain international transfer pricing practices and the forces that influence cost and
management accounting change are very few. As emphasized by Emmanuel and Mehafdi (1994):

“… more academic effort has been expended on building theoretical models than on studying and explaining practice, since the [transfer pricing] problem started attracting serious attention . . .”.

This conclusion is still valid, in particular for international transfer pricing. Most empirical research within international transfer pricing is characterized by being static in nature, which means that it is less suitable to visualize MNEs’ response to changes in environmental and organizational variables over time (e.g. Borkowski, 1990, 1992, 1996, 1997; Chan and Chow, 2001; Chan and Lo, 2004; Chan et al., 2006; Cravens, 1997; Hoi and Lau, 2005; Tang et al., 1979; Wolff, 2007). Those studies constitute significant steps towards the development of a theory for transfer pricing in practice. However, the studies mainly focus on identifying various objectives for MNE transfer pricing policies or determining what organizational and external variables are linked to the use of a certain transfer pricing method. As a result, they offer limited insight into how contextual variables impact on transfer pricing practices in a dynamic way. Thus, our understanding of the change process and the adjustments made to cost accounting systems in MNEs with the aim of adapting to its context remains limited.

Consequently, this paper seeks to expand on the findings of earlier practice studies that investigate the determinants of firms’ transfer pricing methods (e.g. Borkowski, 1990, 1992, 1996, 1997, 2001) and indicate that effective tax management and transfer pricing tax compliance are important managerial objectives (Cravens, 1997; Deloitte, 2007; Ernst & Young, 2003, 2006, 2007). This is done by conducting case-based research at different points in time in order to search for patterns that may contribute to the development of a more comprehensive theory of international transfer pricing.

Although a number of in-depth case studies have been conducted that investigate various change processes of transfer pricing, such studies primarily consider aspects of domestic transfer pricing (e.g. Boyns et al., 1999; Colbert and Spicer, 1995; Eccles, 1985; Perera et al., 2003; Van der Meer-Kooistra, 1994; Van Helden et al., 2001) and thus only provide a limited contribution to the development of a theory of international transfer pricing practices in MNEs. One exception is the contribution by Cools et al. (2008), who investigate changes in the design and use of management controls for tangible goods in a transfer pricing tax compliant MNE. They conclude that increased centralization, a decrease in participative budgeting, and an increase in the use of non-financial performance measures are among the significant changes within the management control system design that take place as a result of implementation of a transfer pricing tax compliance strategy. Conversely, this paper focuses on intra-company cross-border services and addresses the changes to the overhead cost allocation system design caused by implementation of a transfer pricing tax compliance strategy. Our study thus follows earlier recommendations that international transfer pricing research needs to focus on a single intra-company transaction (Emmanuel and Mehafdi, 1998).

Even though intra-company cross-border services are found to be the transaction type most often reviewed by tax authorities (Ernst & Young, 2007), our ability to explain how MNEs adjust their overhead allocation system design to cope with increased external pressure on transfer pricing practices is currently very limited. Recent empirical work indicates that intra-company cross-border transfers of services are the main transfer pricing issue in MNEs (Elliot and Emmanuel, 2000b, p. 15). However, little explanation is offered as to why services present particular challenges and how this impacts on the design of MNE overhead cost allocation systems.

Specifically for overhead cost allocations, the literature emphasizes as one of the main reasons why firms allocate costs that cost allocations can serve as a tool to control the behavior of managers and make them make decisions that are in the interest of the entire firm (e.g. Blanchard and Chow, 1983; Bodnar and Lusk, 1977; Horngren et al., 2009; Kaplan and Atkinson, 1998; Thomas, 1980; Wells, 1980; Zimmerman, 1979). Similar reasons can be found for firms adopting transfer prices, since transfer prices can serve as a form of behavioral control mechanism (e.g. McAulay and Tomkins, 1992; Zimmerman, 2006). There are also a number of empirical studies of cost allocation practices (e.g. Atkinson, 1987; Ramadan, 1989; Scapens et al., 1988; Wouters, 1996), but these studies either do not consider aspects of overhead cost allocation from a taxation point of view or merely find that taxation issues are one objective among many for the existence of cost allocation and transfer pricing (e.g. Atkinson, 1987, p. 53). There is also a body of knowledge that considers how different overhead cost allocation techniques, e.g. activity-based costing, are implemented and the consequences these techniques have for the accounting discipline, see Brierley et al. (2001) and Gosselin (2007) for comprehensive reviews. However, the implications for transfer pricing tax compliance do not play a significant role in these studies. In general, the dynamics of accounting change remain a somewhat neglected area of accounting research, despite the fact that such studies are relevant in explaining the present state of accounting and in providing management with a foundation of devising improved accounting procedures and techniques (Boynt et al., 1999). The strength of case studies is that they offer the opportunity to acquire a deeper understanding of management and cost accounting practices; “both in terms of the techniques, procedures, systems, etc. which are used and the way in which they are used” (Scapens, 1990, p. 264). Furthermore, as pointed out by Gephart (2004, p. 455): “an emphasis on situational details unfolding over time allows qualitative research to describe processes”. Thus, a case study research strategy is considered suitable for answering our research question:

“How does implementation of a transfer pricing tax compliance strategy change the overhead cost allocation system design in a MNE?”

The paper is initially motivated by the abovementioned contribution by Cools et al. (2008), who found that transfer pricing tax compliance is an important contin-
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