International Transfer Pricing: Pointers towards Performance Evaluation of Profit Center Head

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Abstract:

International Transfer Pricing today is a subject of high discussion amongst multinationals. Research indicates its use for Tax management, strategic purpose as also for management control purpose. The issue is further highlighted by the fact that the international related party transactions are now more than 60% of international trade. This fact brings up serious questions regarding the implementation of the concept of profit center as a type of responsibility center. The paper points towards the diversion from performance evaluation criteria given under the profit center that is profit. This paper finds pointers towards the changes in the performance evaluation criteria other than profit for a profit center head, through extensive literature survey and discussions with industry professionals.

Keywords: Transfer Pricing, Performance Evaluation, Profit Center, International Trade.

Introduction:

The theory of profit center tells that the performance evaluation criteria for a profit center head should solely be profit of the division. The assumption under the theory that the head of the profit center gets full autonomy and control over the inputs and outputs and that his sourcing decisions are independent is valid only in theory. The corporate level objective always takes a priority and the full autonomy expected is diluted. There are various reasons for this dilution in the autonomy.

The major reason is to achieve the central corporate goal. This gives birth to the utility of transfer price. Other than management control, transfer pricing has numerous other utilities such as investment purpose, risk management purpose, cash management purpose, tax management purpose, protecting intellectual properties and trade secrets or optimum utilization of the firms resources. In any of the above situation the autonomy of the profit center head is lost. In these situations the only option is to have some additional criteria other than profit for the performance evaluation of the profit center head.

This paper finds pointers to the performance evaluation criteria for profit center head considering the international transfer pricing and issues relating to varying environment in foreign subsidiary of a MNC. The fact that this subject is one of the closed doors subjects in the corporate world makes study more reliant on secondary and tertiary sources of data and small pieces of primary data to support the evidences found in the secondary sources.

Methodology:

Literature survey was used as a source of data to find relevance of the profit as a performance evaluation criteria for performance evaluation of the research center head. The theory that divisional profits are to be the sole criteria for performance evaluation of the profit center was challenged.

Further survey into the utility of transfer price was conducted to find alternative strategic use of transfer pricing was conducted. This was also relied upon for through secondary and tertiary sources.

Unstructured interviews of 15 respondents which included corporate heads and tax authorities were conducted which were then horizontalised to find pointers to relation of international transfer price and performance evaluation of profit center.

Literature Analysis and Data Analysis:

Reasons for restrictions on autonomy of profit center head.

There is a lot of literature written (Choe & Hyde, 2004), (Korn & Lengsfeld, 2004), (Shunko, Debo, & Gavirneni), about the international transfer pricing being used as tool for PAT maximization and global tax management.

The theory for the international financial management gives use of transfer pricing as a tool for cash management and risk management as well as resource allocation (Choi & Meek, 2009), so do the theories of international business.

(Cravens, 1997), found through a survey that the MNC's employ transfer pricing for assisting in achieving competitive advantage along with other corporate goals. It is also found that the transfer pricing influences measures of corporate performance and contributes towards the corporate objectives. The respondents agree that transfer pricing is not purely tax driven mechanism.

(Alles & Datar, 1998) Focus on the use of cost for strategic purpose. In Oligopolistic firms generally the pricing decisions are based on the costs that are communicated to the marketing or selling departments. Thus the sales price determination gets the basis of communicated cost than actual cost. They find imperial evidence in the belief that there is a strategic component in cost system choice and transfer pricing and the fact that the firms may cross subsidize their products.

(Gabrielsen & Schjelderup, 1999), find that in case where the downstream firms buying from upstream firms, are co-owned through joint ventures or otherwise, the transfer pricing is generally over invoiced. Their analysis indicates that transfer pricing plays a strategic role other than tax management even in co-owned downstream firms of MNC's.

(Martini, 2005), focus on the issue, where the same transfer price is employed to coordinate divisions and to determine their profits. It is presumed that the transfer prices are at arm's length price. It is found that under negotiated transfer prices, divisional profits are always Pareto efficient but substantially vary with the scheme, whereas there may occur Pareto-inefficient divisional profits that are invariant with the scheme when transfer prices are administered by headquarters.

(Sikdar, 2006) explains how MNC's are born for which one has to look at the organizational expansion and evolutionary stages in which the sole proprietor business has grown to a multi-national enterprise, in which the control of the owners is delegated through the board of directors and the group of enterprises work together towards achievement of their common business objective. With the industrial revolution the organizations started to grow in size and with revolutions in transportation and communication, movement of funds, labor, and ideas across geographies and political boundaries became effective, efficient and easy. The locational advantage started to be appreciated for its cost efficiency and administrative effectiveness. The companies expanded to different locations which gave them business advantages by way of having branches, affiliates and subsidiaries. This geographic expansion by the companies through branches, affiliates and subsidiaries gave birth to multi-national enterprises. In this case the evaluation of fairness of the price applied in a transaction with related person arises only where the interested party is adversely affected, that is the transaction generally fetches lower than normal collections to the revenue authorities. Thus the transactions that happen between related persons located in different states are subjected to transfer pricing. Transfer pricing can thus, be said to be as old as international transactions or inter-state transactions. Initially when the organizations were small the international transactions were generally trade of finished goods or raw material between unrelated parties, from place of production to place of consumption. This did not involve much of transfer pricing issues.

(Cools & Emmanuel, 2006), highlight the problem of adoption of tax compliant strategy on design of management control system. The complex relationship between the sub-units contributes towards the economic co-ordination and performance measurement of the affiliated sub-units. They agree to the fact that international related party trade gives rise to the opportunity to MNC's to optimize global PAT. They find that since 1990 the increased fiscal regulations and compliance to the same have become a potential alternative strategy to overcome clash with the management control system prevailing in the MNC.

(Martini, Niemann, & Simons, 2007), acknowledge the problem of coordinating economic decisions like investment or production within MNC's. The findings suggest that transfer prices are a widespread device for splitting up complex decision situations and allocating the responsibility for the resulting sub problems to several decision makers. Their findings suggest that transfer prices are a widespread device for splitting up complex decision situations and allocating the responsibility for the resulting sub problems to several decision makers. However apart from doing this transfer prices are also used for tax management.

(Shor & Chen, 2008) They find that the firms can use TP strategically as a collusive device. Firms are individually better off in a centralized organizational format. Collusion on prices is sustainable whereas on numbers is not as well the price collusion may also escape legal scrutiny. Cost-shifting between regulated monopolists and their corporate affiliates is regarded as a major concern for regulators and researchers.

(Cools & Slagmulder, 2009) Study the effect of international transfer prices within management control systems. The study is limited to firms using single transfer price for management control system and that of tax purpose. In this situation the TP negotiations are eliminated giving rise to economically harmful decisions. Administrative mechanism for profit determination can lead to suboptimal decisions and lastly revenue or cost centers are designated as profit centers for tax compliance. TP and tax compliance is related to profit centers. In the case study undertaken it was found that the management found utility in treating the associate as profit centre than revenue or cost center.

(Jelena & Danijel, 2010) Find that the transfer pricing affects the divisional revenues, expenditures and results. This creates competition amongst the divisions for increasing their performances. The method used for transfer pricing is thus plays an important role and is of most interest to the managers. They also find that the more successful divisions get more share in the allocation of resources.

In MNC's where the transfer pricing is not used as a strategy for tax planning, there is a very strong case that the tradeoff is made by the managers of the divisions between benefits of tax management and higher share in resources from the management. Also there will be considerations given to the performance based bargaining capacity of the division manager which can have impact on the transfer pricing method as well as price.

(Sikka & Willmott, 2010), highlight on the scattered evidence to show how transfer pricing is not just an accounting technique, but also a method of resource allocation and avoidance of taxes that affects distribution of income, wealth, risks and quality of life.

The above literature brings out reasons as to why the autonomy of input and output pricing for a foreign profit center manager is lost in a MNC setup. There is sufficient evidence that the corporate goals take priority. In this process international transfer pricing is used as a tool for various international investment management, risk management, cash management, tax management, to protecting intellectual properties and trade secrets and optimum utilization of the firms resources. In any of the case above the profit center head loses his autonomy of control over pricing of inputs and outputs and hence the criteria of profit for performance evaluation cannot be implemented absolutely. There is a case that the profit center head gets uncontrollable factors due to managerial decisions in the wider interest of the firm.

Additional performance evaluation criteria for profit center head in international case.

(Sharav, 1974) has identified that transfer prices can vary over a wide range from freely negotiated to the administratively dictated. It is more governed by the corporate goal congruence.

(Abdallah, 1989) states that due to foreign exchange rates the transfer pricing policies will lead to financial distortions and the performance evaluation criteria in international case will have to take case of this fact. The Evaluators will have to look into keeping the divisional managers motivated through some other parameters for performance evaluation.

(Dutta & Anctil, 1999) identify the feature of interdepartmental transfer price to be the interdivisional risk sharing. This has an impact on the design of optimal compensations contracts which are liner function of divisional profits and that of firm wide profits.

(Abdulla, Firoz, & Ekeledo, 2005) assess 1. Whether the global performance evaluation measures used are in response to foreign environmental challenges. 2. Whether the relative performance of foreign subsidiary managers reflects the objectives and the operational performance measures of their companies, 3. How frequent changes in currency rates effects the performance of the managers. They find that the performance evaluation has to be based on functions that he performs in relation to the environmental factors present in the foreign subsidiary country. They also find that advanced management accounting methods are required to be developed for the evaluation of foreign subsidiary's manager.

(Schmid & Kretschmer, 2010) review the contingency framework for performance evaluation and find contradictions or no significant impact of influencing factors.

From the above cases it is clear that the business environmental factors vary from country to country and hence objective comparison of performance of two profit center heads is not possible. Also fluctuations in the currency rates can play misleading role for the evaluation of performance. In doing this the operational performance and the operational efficiencies achieved are neglected and the evaluation system has to take case of this aspect. Uncontrollable external factors also effect the performance of the profit center head and the same is not similar for different foreign subsidiaries of the MNC making it difficult for comparing the performance of different heads of different subsidiaries.

Thus the performance evaluation criteria for a head of foreign subsidiary (profit center head) can be divided into two categories; namely controllable factors and uncontrollable factors. The uncontrollable factors can be further divided into uncontrollable due to management decision and uncontrollable due to external factors.

The performance evaluation criteria should to stick to the controllable factors and actions taken to reduce impact of external uncontrollable factors, also uncontrollable factors due to management decision that create external uncontrollable have to be separately dealt.

Indicators from practice:

Interviews conducted give clear indications towards the use of transfer price other that management control. The respondents were clear that the transfer pricing was used for tax management purpose or other strategic purpose. This is in line with the findings in the literature. It conclusively brings out the fact that the management decisions create uncontrollable factors for the foreign subsidiary manager. These may be considered as the limiting factors for the manager for his execution of job thus qualifying as uncontrollable factors due to managerial decisions. It was also revealed that the profit was not the only criteria for performance evaluation of the foreign subsidiary head of the MNC. This contradicts the theoretical concept of the concept of profit center.

Findings:

The foreign subsidiary head of a MNC may not be actually working as a profit center head as given in text books. The theoretical criteria for the profit center requires the manager to have full control and autonomy on decisions of sourcing and pricing of inputs and outputs. The input and output pricing decision that have to be under the control of the manager, are actually out of his control. The decisions are made by the management and implemented which become the limiting factors for the manager.

The factors determining the performance of the profit center head can be divided into controllable and uncontrollable factors. The uncontrollable can be further divided into uncontrollable due to management action and other uncontrollable factors. The uncontrollable factors due to management action can also lead to other uncontrollable factors. The performance evaluation requires that the evaluated has to have autonomy of performance and the factors for performance should be under his control. The manager of the profit center has limitation put forward by management decision and the environment. This is out of control of the manager and hence out of preview of his performance evaluation. The profit in this case is not 100% in control of the manager, hence the same has to be modified for the uncontrollable factors.

Further the external uncontrollable factors for comparison between the two managers vary in different subsidiaries. This makes the base of comparison different and hence the impossible. This creates a case for separate evaluation or creating a rating for the different external uncontrollable factors for the managers.

Conclusions:

A completely new management accounting system has to be developed which will take care of the uncontrollable factors created due to the management decision. The performance evaluation criteria should also consider the efforts made by the manager in handling the other uncontrollable factors. The business environment in different countries is different and hence not always the performance of one manager can be compared with that of the other. Hence diversions from the concept of profit as a basic performance evaluation criteria has to be given away with, in view of the varying environment and external uncontrollable factors.

Conclusion is drawn that the foreign subsidiary head of MNC (profit center head) is to be treated as a profit center head for the functional ease but when it comes to his performance evaluation profit cannot be the only criteria for performance evaluation. A new management accounting system has to be evolved to evaluate the decisions made upon uncontrollable factors.

A new rating system for comparison of the profit center heads has to be evolved so as to ensure that the decisions in varying business environments has been given justice and due consideration is given to the efforts of the manager. Direct comparison of the profits of the two divisions will not be correct comparative performance of the two managers in different environments. The two environments have to be got to become comparable for this kind of analysis or the evaluation is to be completely independent without comparison with the other profit center head.

The performance evaluation method for the profit center head in international MNC scenario should ideally be three fold with profit as a major component, rating for environment and a new developed management accounting system to take care of uncontrollables due to managerial decisions.

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