The Ethics of International Transfer Pricing

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ABSTRACT. The pursuit of economic opportunity has frequently put transnational manufacturing enterprises in the spotlight, accused of contributing to, if not causing, economic hardship, social deprivation, unsustainable growth, labour exploitation, resource plundering and ecological degradation in home and host countries. A substantial part of international trade now consists of intra-firm sales, or commercial transactions between units of the same business corporation, within or beyond the national borders of the parent company. Known as *transfer pricing* and viewed as a legitimate business opportunity by transnational corporations, it is often used to misrepresent financial success and evade taxation. This has recently instigated many fiscal agencies and governments to take more draconian measures than ever before to protect national financial interests. However, while the fiscal legality of transfer pricing practices is now carefully scrutinized, the heightened interest in its tax aspects has neglected the considerable ethical issues it entails. Unethical transfer pricing behaviour consumes scarce resources, causes costs but does not create value. This paper identifies and discusses some of these ethical issues and assesses their implications for the internalisation of trade, the design of transfer pricing systems, and international tax rules. Opportunities for future research are also outlined.

KEY WORDS: arm's length principle, ethics, foreign direct investment, intra-firm trade, tax evasion, transfer pricing

GLOSSARY: Transfer prices = prices or payments for transfers (internal sales) of goods and services between sections of the same company or group; Arm's length principle = international transfer pricing standard based on using prices for transactions between unrelated companies (or market prices) for setting transfer prices.

Introduction

Transfer pricing (TP, henceforth), the pricing of intra-firm transactions of tangible and intangible goods, has undeniably become a major international tax issue,[1] locking transnational corporations (TNCs) and tax authorities into contestable court battles over tax avoidance and evasion through inflated transfer prices. Usually associated with large decentralized manufacturing companies and widely discussed in the management accounting literature, TP now occupies centre stage in international tax litigations because in many countries $ billions worth of tax revenues are believed to be lost in the "TP blackhole" through false accounting. Although it has attracted a tremendous research and legislative effort to "solve" its technical aspects, its equally pertinent ethical aspects have been overlooked. The TP problem is equally pertinent in the service sector. A recent example of TP misuse is that of Morgan Stanley & Co., fined $1 million in the U.S.A. by the Market Regulation Committee of the National Association of Securities Dealers (NASD, April 13, 1998) for manipulating the price of 10 securities that underlie the NASDAQ 100 Index. The price manipulation involved intra-firm dealings between the company's OTC Desk and its Program Trading Desk to lock and cross markets. Both the sentencing of the company and the substantial personal fines imposed on its traders reflect the unethical use of intra-firm trade and pricing that this paper discusses.

TP litigation cases are complex because, as Figure 1 illustrates, TP is a complex process that crosses organizational boundaries and transcends simple pricing formulae and accounting numbers

Journal of Business Ethics **28**: 365–381, 2000.

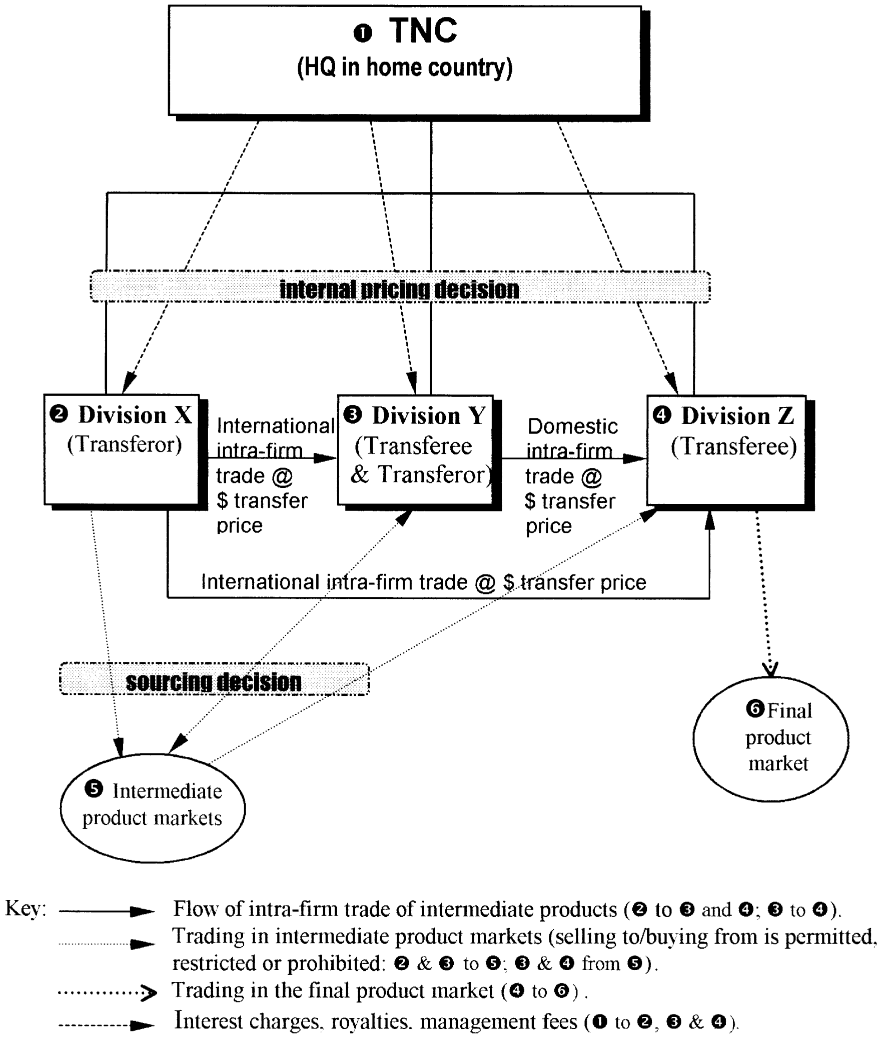

Figure 1. Transfer pricing linkages in a hypothetical 3-division decentralised TNC.

by pulling together various internal and external variables in the sourcing and internal pricing decisions of tangible and intangible goods and services. Organizational boundary management and competition for scarce resources often result in political control taking precedence over sound TP practice. Explicating the ethical issues involved in this process is the theme of this paper, observing at the outset that, although TP has become a real bone of contention between TNCs and tax authorities, TP problems are not just about transfer prices *per se*. As they are mostly determined inside companies, transfer prices are delimited by and inseparable from the wider organizational, managerial and cultural characteristics of TNCs.

TP is complex enough in the domestic market where the transfer price that Division Y charges Division Z for an intermediate product may be used for a host of conflicting objectives, such as resource allocation, profit maximisation, motivation and performance evaluation, but may satisfy none in the end. In manufacturing companies, internal transactions usually involve intermediate products such as components and sub-assemblies for which reliable external markets may or may not exist, depending on product idiosyncrasies. The management accounting literature is replete with "cure-all" but often impractical solutions (see Thomas, 1980; Eccles, 1985; Grabski, 1985; McAulay and Tomkins, 1992; Leitch and Barrett, 1992; Emmanuel and

Mehafdi, 1994 for comprehensive reviews of theoretical and empirical studies). Anchored in neo-classical economics and sometimes embellished with mathematics, the theoretical models recognise that, since the transfer price is a revenue for the transferor – Division Y – and a cost for the transferee – Division Z – it affects divisional financial results in opposite ways. Supposedly autonomous divisional managers can become locked into endless wrangles especially when TP policies are imposed by central management and divisional managers are not allowed to transact in the intermediate product market at more favourable terms. Internally determined cost-based transfer prices are more problematic than market based ones because the transferor's full costs carry arbitrarily allocated costs and any process inefficiencies. TP conflict between divisions and with central management can lead to sub-optimal and resource squandering behaviour such as slack building and budgetary information bias to offset the effect of TP on divisional financial results. The related effect on value creation throughout the supply chain has so far not been addressed by research, nor have the ethical issues.

The problem is more complex in an international context – transfers of tangibles from Division X to Divisions Y and Z, as well as centrally charged fees and loan interest in Figure 1 – where two or more national tax jurisdictions are involved. It is mainly within this context that TP ethics are discussed in the remainder of this paper. To put the ethics of international TP into a clear perspective, this introductory section is followed by an examination of the relationship of intra-firm trade and foreign direct investment and the recrudescence of international legislative efforts. A framework of analysis is then presented for the ensuing discussion of the ethics of intra-firm trade and pricing. The final part consists of suggestions for future research.

Transfer pricing in the world: intra-firm trade and FDI

The international significance of TP can be gauged from the amount of global intra-firm trade valued in the early 1990s in $ billions (Freeman, 1991; Curet et al., 1996; Turner, 1996; Wang and Connor, 1996) and current estimates by the IMF, the OECD, the UNCTAD and the WTO[2] talk of a ball park figure of $1.6 trillion or one third of world trade. This mirrors the current high degree of company transnationality and the unprecedented levels of foreign direct investment (FDI) with a current annual flow of over $400 billion and a capital base of around $3 trillion (Hill, 1998; UNCTAD, 1998). OECD member countries alone account for around 60% of investment inflows and 85% of outflows and the intra-firm portion of these flows is regularly monitored in the *Activities of Foreign Affiliates* database compiled by the OECD. FDI and intra-firm trade are almost inseparable because it is through intra-firm rather than arm's length transactions that most FDI business takes place (UNCTAD, 1998; WTO, 1998). In vertical FDI, TNCs locate different stages of the production process in different countries, usually to take advantage of country differences in input costs, using intra-firm trade as the link between the various locations. This involves long-term investments and management control of resident entities in host countries. Intra-firm trade is particularly high when FDI is export-oriented as is the case with Compaq in Singapore with 81% of its output going to subsidiaries in other countries (Lien, 1997).

For individual industrial sectors, intra-firm trade varies from negligible amounts to a materially significant percentage of production volume and value, with a range of 30–80% in the knowledge-intensive and highly transnational industries of electronics, chemicals and pharmaceuticals (Emmanuel and Mehafdi, 1994; OECD, 1996). For intangibles, it is estimated that intra-TNC technology transfers exceed 70% of global payments of royalties and fees (Wolf, 1997). With the formation and expansion of the ASEAN, EU and NAFTA economic blocks, and the hastened globalisation of economic activity through the economic liberalisation programmes of the WTO, intra-firm trade can only gain more momentum (OECD, 1996). Technological change, declining transportation and communication costs and the removal of trade barriers

(Wolf, 1997) make it possible for TNCs to serve integrated markets from multiple production sites with an ever increasing number of intermediate products becoming central to global FDI activity (UNCTAD, 1998). For instance, 80% of manufactured exports in the U.K. are now intra-firm (Dicken, 1998) compared to 40% in Japan (Anderson and Cavanagh, 1996). The U.S. Department of Commerce[3] estimates that intra-firm trade accounts for over 35% of U.S. exports and more than 40% of imports, noting that 65% of total trade deficit in 1994 consisted of intra-firm trade.

The upward FDI trend and the concurrent increase of cross-border intra-firm trade deepen global economic interdependence and entangle the interests of TNCs and host governments. As recipients of FDI, the latter repeatedly accuse the former of manipulating transfer prices to evade and avoid taxation by over-invoicing imports to and under-invoicing exports from affiliates. International legislation embodied in Section 482 of the U.S.A. Internal Revenue Code and the OECD *Guidelines* (1979, revised 1995, 1996, 1997, 1998) and emulated by national legislation in many countries, seeks compliance with the *arm's length* principle which states that intra-firm transactions should be priced as if they were with independent parties transacting in the open market. Persistent non-compliant behaviour by many TNCs and the loss of $ billions in tax revenue has prompted many countries and regulating bodies to adopt stringent laws to curb TP abuse and the resultant misrepresentation of taxable profits. Investigations by tax authorities of offending companies are usually intrusive and expensive and result in substantial transfer price adjustments (i.e. additional taxes) and hefty penalties.[4] Although the imposition of huge non-compliance penalties on companies may be interpreted as a punishment for unethical behaviour and a deterrent for potential future offenders, the ethics of TP have always been eclipsed by the focus on the financial aspects of tax.

A framework of analysis of TP ethics

Business ethics are, inter alia, about corporate codes of conduct in pursuing wealth creation. In trying to frame TP ethics, four observations need to be made.

First, in the absence of compelling financial reporting regulations,[5] companies will continue to keep their TP policies under wraps and prevent a direct observation of their non-tax aspects. This is a known obstacle to empirical TP research (Emmanuel and Mehafdi, 1994).

Second, although the business ethics literature recognises that the activities of TNCs spawn ethical controversy (Donaldson, 1989), it only discusses commercial transactions between unrelated parties and has, like the specialised TP literature, so far overlooked the ethics of intra-firm trade and pricing. This is compounded by the paucity of background institutions to control international cross-border business activities (DeGeorge, 1993).

Third, apart from a passing reference by Knowles and Mathur (1985) to the importance of the ethical and legal perspectives, the vast TP literature which is generally grounded in the neo-classical unitary view of the firm has concentrated on finding the "magical pricing formula" for internal transactions. For cross-border transactions the focus has been on the financial aspects of tax and, to some extent, on contingent variables that affect and determine a company's TP policies to minimise its global tax bill (see for example Borkowski, 1992; Tang, 1992; Cravens and Shearon, 1996). Overall the emphasis has been on pricing formulae and rules that apparently work, not on what is necessarily right. There are only "proxies" to ethics in the few instances where the issues of fairness, conflict and dysfunctional behaviour were discussed (e.g. Watson and Baumler, 1975; Lambert, 1979; Larson, 1979; Emmanuel and Gee, 1982; Eccles, 1985; Chalos and Haka, 1990; Borkowski, 1990; Emmanuel and Mehafdi, 1994).

Fourth, a common accounting misconception is to look at TP as a purely internal cost matter and that internal selling and buying cancel out, with a resultant nil effect on corporate profits and cash flows. This is a parochial view which ignores the decision-making process involved in intra-firm trade (Mehafdi, 1998). In this process, organizational and personal factors that govern intra-firm transactions determine the moral fitness of actions, with central management and the managers of the trading divisions as the key players. The profit centre structure in large companies requires transferors and transferees to behave like independent suppliers and customers, each wanting to clinch the best deal. If their aspirations and objectives are hindered by the rules that govern the internal trade, this naturally triggers opportunistic behaviour and sub-optimal decision-making (Vancil, 1979; Eccles, 1985; Emmanuel and Mehafdi, 1994; Colbert and Spicer, 1995) which squanders scarce resources, destroys value and incurs unnecessary costs which eat into profits and cash flows (Mehafdi, 1998).

Since TP is a process, the discussion of the ethical aspects should focus on the main elements in this process depicted in Figure 1, which are *the decision to internalise trade*, *the pricing decision*, *internal supplier-buyer relationships*, *the role of central management*, and *external parties*. These elements of the process are conditioned by the process's organizational context within which an (un)ethical climate prevails (see Figure 2). Central to the analysis is that TP business is not always ethical and can thus engender hidden costs or externalities not reflected in the transfer price, regardless of whether the price is market or cost-based. The prevalent climate carries implicit and explicit incentives for (un)ethical behaviour. If the TP process is not grounded in sound values it lacks the safeguards that can prevent TNCs from engaging in activities that can be detrimental to the interests of host countries. From the utilitarian business ethics literature which emphasises the outcomes of behaviour, the notions of *harm*, *propensity of harm*, and *whistle-blowing* are used to frame TP ethical issues. Harm can be physical, economic and psychological and, depending on its propensity, it influences the moral reasoning criteria in dealing with ethical problems (Collins, 1989; Jones, 1991; Weber, 1996). It is difficult to gauge the types and extent of TP harm from existing empirical studies[6] as they mostly focus on TP methods, not the outcomes of TP policies. Empirical studies also report corporate views, not the views of units directly involved in specific intra-firm transactions and thus produce highly aggregated data. Hence the need for empirical studies that specifically address TP ethics.

Figures 1 and 2 depict TP interactions of varying degrees of complexity throughout the supplier-customer chains of raw materials through to final products. These interactions or interdependencies impact on operations, results, intra-organizational relationships and behaviours. Moreover, the very fact that intermediate products consume scarce resources and then become integral parts of final products, especially in sequential production processes, makes a company's TP business and its external world firmly intertwined, fiscally, ethically and otherwise. Therefore, TP cannot be confined to a narrowly defined "internal business" and, focusing solely on the tax aspects, ignores the various types and degrees of harm that TP can cause within and outside a company. Figure 3 illustrates the possible types and recipients of TP harm.

The perception of and reaction to the harm is affected by a host of factors such as the company's experience with TP, the existence of intermediate product markets, the flexibility of the rules governing the internal transaction, the importance of the intermediate product to each transacting party, the financial performance evaluation system, tax regimes and interpretation and implementation of the arm's length legislation. Where there is harm there are victims who need to be compensated. In TP situations, the victim of the harm could be the transferor, the transferee, the company as a whole, or an external party (see Figures 2 and 3). Quantifiable harm should be translated into transfer price adjustments to compensate the affected party. Psychological harm that TP can inflict is the least tangible and quantifiable and, therefore, difficult to compensate equitably. The remainder of the paper discusses the possible types of harm

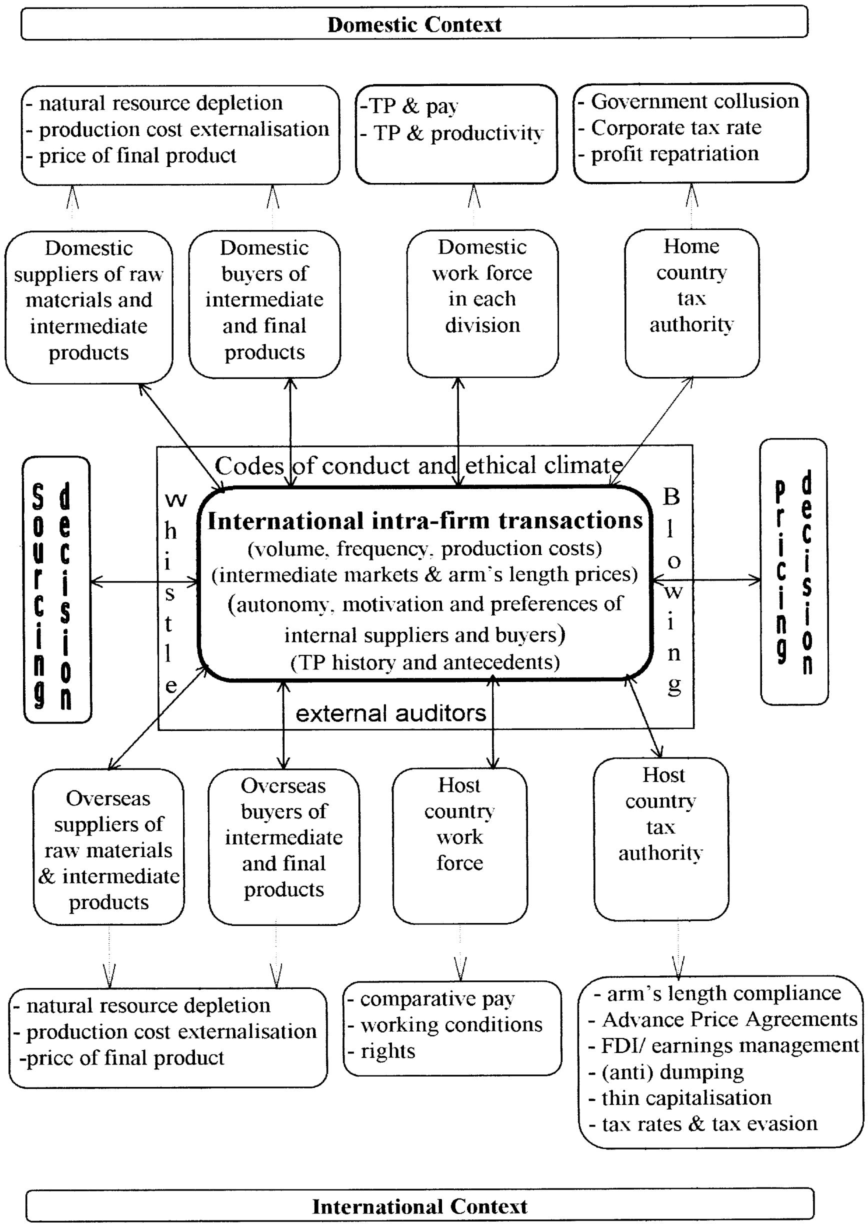

Figure 2. Ethical determinants of international transfer pricing.

involved in the sourcing and pricing decisions and their implications for fiscal regimes and the design of TP systems. Future research implications are then drawn.

The ethicality of intra-firm trade and the sourcing decision

Economic justifications of intra-firm trade

Figure 1 depicts typical intra-firm relationships where one division (the internal supplier or transferor) makes and sells a tangible intermediate product to another division (the internal customer or transferee) where it is processed

Consequences and recipients of TP harm*

Type of possible TP harm	Transferor (divisional manager)	Transferee (divisional manager)	Company (top management; shareholders)	Host country (tax authority; workforce; environment)
Physical	- wear and tear of division's assets - depletion of inventories	- wear and tear of division's assets - depletion of inventories	- wear and tear of company's assets - depletion of inventories	- depletion of natural finite resources - environmental damage - health hazards to local workforce and wider society
Economic	- loss of return on assets - loss of sales revenue - loss of cash flow - loss of market opportunities	- loss of return on assets - loss of sales revenue - loss of cash flow - loss of market opportunities	- legitimacy costs - less value created - reduced profits - loss of cash flow - loss of market opportunities	- loss of tax income - loss of subsidies and other investments in FDI. - increased national debt - increased poverty
Psychological	- loss of control - loss of self-esteem - loss of trust in transferee and top management	- loss of control - loss of self-esteem - loss of trust in transferor and top management	- tarnished image - loss of control - loss of trust in divisional managers	- feeling of betrayal - loss of trust in TNCs - feeling of domination by 'economic colonialism'

(*) the intensity of the harm depends on the magnitude and frequency of intra-firm trade.

Figure 3. Types and consequences of TP harm.

further. Transfers to Divisions Y and Z are converted into or become part of final products. Intangibles, such as finance, technological and management expertise, are also "sold" by the company to its constituent divisions at usually disputable internal prices. In any one firm, internal trade may involve core or strategic activities as well as non-core or "outsourceable" activities, thus making it difficult to affirmatively discern, at least from existing empirical studies, any valid reasons for internalising trade in the first place (Emmanuel and Mehafdi, 1994, 1997).

Although the extant TP research tells very little about the magnitude of intra-firm trade in individual companies (Emmanuel and Mehafdi, 1994, 1997), three market justifications for internalising trade prevail in the business literature: savings on *transaction costs* (Coase, 1937; Williamson, 1975), a product's unique features or the degree of *asset specificity* (Williamson, 1975; Spicer, 1988; Cho, 1990; Colbert and Spicer, 1995), and the *ownership-location-internalisation* paradigm which emphasises market imperfections for justifying FDI (Casson, 1987; Dunning, 1988; Hill, 1998). Underlying these arguments is the pursuit of economic growth and profit maximisation which constitute the main *raison d'être* for many TNCs, especially when under pressure from the capital markets for short-term financial results. The abundant TP literature, both theoretical and empirical, is mostly anchored in the mass production era and does not question this *raison d'être*. It takes the volume of internal trade for granted and focuses instead on the pricing aspects, not the harm that TP policies might cause within and outside a company. Elaborate theoretical models developed by Eccles (1985), Spicer (1988) and Emmanuel and Mehafdi (1994) are largely couched in these terms as well.

Intra-firm trade from an ethical perspective

Even when a transfer price is settled for and cannot apparently be surpassed, the established rationale of intra-firm trade can be challenged on ethical grounds for at least five reasons:

First there is ample evidence that companies engage in internal trade to circumvent restrictions on funds movement and misrepresent tax bills (Hill, 1998; Oyelere and Emmanuel, 1998).

Second, the variety of internal trade reported by research (e.g. Emmanuel and Mehafdi, 1994, 1997) or reported in landmark court cases (e.g. Hill, 1998) defies any FDI logic. In other words, FDI may yield only a short-lived positive balance of payments effect when TNCs engage in heavy imports of intermediate products to and from their affiliates at distorted transfer prices and shift taxable income to low tax countries.

Third, the intermediate product or the final product that comprises it, may fall into an unethical category of products especially when the TNC shops around for low regulation environments (e.g. involves experiments on live animals; involves child labour in host countries; damages health; degrades/destroys life; damages the environment; etc.) thus making the internal trade ethically unjustifiable, even if it apparently "saves on transaction costs", "is highly investment specific", and "satisfies ownership and locational strategies". The harm can be physical, financial and psychological and a manager's choice may be limited to toeing the company line or resigning their job on moral grounds.

Fourth, when the intermediate product may be assumed "perfectly ethical", the internalising of the transaction can still be questionable. Company policy may reduce transferor and transferee to pseudo or ineffectual managers by centralising the sourcing decision even when outsourcing is the better option. It is not uncommon in supposedly decentralised companies that neither the transferor nor the transferee control the sourcing decision, yet they are expected to meet pre-determined financial targets (Vancil, 1979; Eccles, 1985; Emmanuel and Mehafdi, 1994). In other words, top management may dictate TP policies that divisional managers would have no option but to accept even if those policies wasted resources. If the transferor is a monopolist and discriminates between transferee divisions, this would complicate things further. A transferee may not be allowed to select suppliers or terminate an internally non-viable trading relationship, thus creating a problem in decision-making that can incite managers to act unethically, for example by spending less on maintenance in order to balance their TP-affected results. As Weber (1996) shows, the "locus of control" tends to correlate positively with ethical decision making. If outsourcing the intermediate product reduces scarce resource wastage, then persisting in internalising products that other companies can do better cannot be ethical. A fundamental condition for the good functioning of a market economy is the elimination of inefficiencies through rational allocation and consumption of scarce resources (i.e. allocative and productive efficiencies). Economists insist on the internalisation of all the costs of production to prevent manufacturers amassing unearned profits while causing market inefficiencies. A "*just do it*" dictate (Badaracco and Webb, 1995) means that ineffectual managers cannot stop what Korten (1995) aptly describes as "the privatising of profits and socialising of costs". Allocative and productive efficiencies, which are central to the transaction costs paradigm mentioned earlier, should take precedence over vertical integration led by corporate financial greed. Responsive and efficient outsourcing creates better value for the modern company (Copeland et al., 1995; Deloitte, 1998) than unethical insourcing policies.

Finally, related to the above point is the issue of sustainable development which, despite its importance,[7] has hitherto surprisingly not figured in the extensive TP debate. In a world where:

- exponential growth is espoused by the globalisation and liberalisation agenda with TNCs as the prime beneficiaries of unprecedented levels of FDI and intra-firm

trade (Karliner, 1997; Wolf, 1997; UNCTAD, 1998);
- TNCs account for most of the world's industrial capacity and international financial transactions, hold 70% of world trade almost free from government control, and 90% of all technology and product patents worldwide (Karliner, 1997);
- the $7.1 trillion combined sales of the top 200 TNCs are bigger than the combined economies of 182 countries (Anderson and Cavanagh, 1996);
- the 100 largest TNCs alone account for over $2 trillion in foreign sales and one fifth of global foreign assets (Schmidheiny, 1992; Wolf, 1997; UNCTAD, 1998);

intra-firm trade as a global phenomenon must be contributing to the irresponsible depletion of the planet's finite resources in one form or another.[8] This causes irreversible environmental damage (Korten, 1995; Welford, 1998) that no existing TP theory could justify, regardless of how the argument of "transaction costs" is marshalled to do so. While the company may "save on transaction costs" for itself, it may be causing unjustifiable costs, such as polluting a river, which are not reported by traditional accounting systems but which are eventually borne by a third party, usually the society at large in the host country.[9] Therefore, is it not logical to say that by internalising trade TNCs must also internalise the social and environmental costs of that trade?

The social and ecological effects of intra-firm trade need serious examination. Driven by economic growth and profit maximisation, the TP practices of TNCs can impede sustainable development by depleting natural resources in host countries, with or without the consent of local politicians. It may be argued that this is just a sub-problem of secondary importance in wider international "green issues". To the contrary, the TP-FDI interlinkage has produced a problem of prime importance that the coveted arm's length principle can totally eclipse. For many TNCs, natural resources are a key FDI determinant. An FDI company may strip a forest bare, or chemically pollute a main river and displace an entire community, yet pay little tax income to the host government through TP false accounting. Timber logging is a typical example where the concept of transaction costs ceases to be meaningful if it does not encapsulate TP externalities, as the sole responsibility of the TNC. The moral responsibility rests with all the parties to the internal trade, namely central management, the transferor and the transferee and, where applicable, uncaring home and host governments.[10] As currently conceived, the much advocated arm's length principle for setting international transfer prices acceptable to tax authorities does not help in establishing this responsibility. This is discussed next.

The ethicality of internal pricing

The extent of the problem

From an ethical perspective, both the TP practices of TNCs and the iron fist approach adopted by some countries to examine those practices may be questionable. In the realm of business ethics, there is no place for dubious TP practices, whether they are market or cost based and whether they disadvantage an internal customer or a host government. Existing research reveals that TP systems do not always receive unanimous acclaim as divisional managers overtly express dissatisfaction or conflict with prevalent policies (e.g. Lambert, 1979; Vancil, 1979; Eccles, 1985; Borkowski, 1990; Emmanuel and Mehafdi, 1994). Stated otherwise, the managers' behaviour reflects perceived financial harm on their divisional results. The psychological harm endured will always be difficult to measure objectively.

On the international scene, TP is skilfully used as an earnings management tool by TNCs who charge inflated transfer prices for intermediate products and services to subsidiaries in high tax countries in order to shift profits to the parent company or another subsidiary in a low tax country (see for instance Emmanuel and Mehafdi, 1994; Oyelere and Emmanuel, 1998 for real examples). This turns FDI and TP into a cover for dubious earnings management, especially when FDI is local-market-oriented and high tariffs are imposed by the host countries on imports. Transferred services include finance, management consultancy, and intellectual property. Whether the company charges inflated product transfer prices, excessive management fees and royalties or pursues thin capitalisation through abnormally high interest charges on internal loans, these are TP aberrations which:

- abuse the trust and hospitality of the host country which may have gone "the extra mile" through subsidies and other concessions to encourage inward investment;
- rob the local workforce employed in the host country of the fruit of its labour. The consequences are worse in the Third World when the TNC takes advantage of low wages, and uses TP to impoverish the host country;
- reinforce politics of greed (imperialist exploitation, especially of Third World countries who are the least protected against TP manipulation);
- tarnish the TNC's image as a credible international business partner;
- cause financial damage to shareholders in the form of sharp share price falls and hefty penalties imposed by tax authorities. A recent case is Powerscreen International which suffered £ millions in costs, additional tax, and loss of share value because of accounting irregularities attributed to TP manipulation (*Financial Times*, 14 April 1998).

By inviting and facilitating investment by foreign companies, host countries expect, and rightly so, positive returns from FDI, not to be robbed of legitimate tax income or to be used as dumping sites. In the politics of international business, legitimacy is a key determinant of profits and, circumventing host country rules, results in paying legitimacy costs (Boddewyn and Brewer, 1994). If the host country is denied its expected share of earnings inflows from FDI, this jeopardises its balance of payments (Dicken, 1998; Hill, 1998). Thus, through the manipulation of transfer prices, TNCs can add to a country's national debt, jeopardise its economic and social programmes and contribute to its population's misery. A lengthy tax probe by the host government to redress the TP situation would eventually tell how much taxing unethical TP practices can be. Paying $ millions in back taxes and fines (i.e. paying legitimacy costs) and tarnishing its image as a credible international partner is a predicament that no TNC would relish in a cut-throat globally competitive market.

Any TNC abusing its TP system probably pursues an apparent economic growth and short-term interests but to the detriment of the host country, and probably its own country. Illicit profit repatriation through the TP mechanism can only contribute to poverty and loss of sovereignty in the host country. It seems that international TP has become an instrument of market tyranny characterised by what Korten (1995, p. 12) calls the "globalised financial system that has delinked the creation of money from the creation of real wealth and rewards extractive over productive investment". Boddewyn and Brewer (1994) suggested that TNCs circumvent host country policies when they perceive that the benefits of doing so exceed legitimacy costs. However, TNCs are supposed to produce more good than harm for host countries (Bain, 1997) and the current state of affairs cries for a global TP ethical code, not just a change of tax legislation to curb international transfer price abuse. Because existing financial reporting regulations do not compel companies to disclose their TP policies, financial reporting ethics need to be addressed as well by future research.

Market-based transfer prices

For over half a century, academic wisdom has advocated market-based transfer prices whenever intermediate product markets exist. Empirical evidence seems to support theory as market-based transfer prices are widely used (Emmanuel and Mehafdi, 1994, 1997; Ernst & Young, 1997), sometimes regardless of strategic implications (Adler, 1996). Although there is an implicit assumption of economic growth and wealth creation underlying the arm's length principle, a market price does not indicate how much cost is externalised by the companies competing in an intermediate product market. As Korten (1995,

p. 40) pointed out "the economic accounting systems by which economic growth is measured make no comparable adjustment for the depletion of social and natural capital".[11] Therefore, externalised costs of intra-firm trade need to be measured and factored into arm's length TP calculations, otherwise TNCs will continue playing "the arm's length game". TNCs which pass the "tax test" because they apparently comply with the arm's length rule, may in fact find such compliance very convenient as their externalised costs go unnoticed or unaccounted for. Therefore, the existence of externalities renders market prices meaningless unless proper adjustments are made to compensate for TP harm.

Cost-based transfer prices

When intermediate product markets do not exist, for example because of product idiosyncrasies, the next best arm's length transfer price is entirely based on cost, i.e. not externally verifiable. However, cost-based transfer prices, in particular actual full cost plus formulae, are fraught will all sorts of anomalies because of subjective cost classifications and allocations, "up-stream" fixed costs, as well as product and process inefficiencies which are factored into the cost and passed on to the transferee through the transfer price.[12] The transferor "externalises" costs onto the transferee – the internal customer – by passing on inefficiencies. When transfer prices are cost-based, there is little incentive for the transferor division to use resources efficiently since the costs incurred are passed on to the transferee division who in turn passes them on to the final customer. It does not matter whether the cost is standard or actual. If the cost is actual, the transferor has a free ride on resources and if the cost is standard the transferor may build budget slack up front. The more resources the transferor wastes, the more input factors have to be obtained, the more depletion of finite resources. Adding an arbitrary profit mark-up to calculate a cost plus transfer price only perpetuates the inefficiencies and is a recipe for resource wastage and complacency.

At the receiving end, the transferee might try to offset the effect of TP externalities on their appraisable financial performance by resorting to "undesirable behaviour" such as:

- building slack in divisional budgets (e.g. overstating costs and capital requirements; understating revenues);
- reducing discretionary expenditure (with consequent negative effects on process efficiency and product quality).

Examples of transfer price adjustments based on Figure 1:

1. If Division X operates in a high tax host country and transfers to Division Y a kilo of mined ore at £100 when the arm's length price is £150, this reduces X's tax bill by (£50 × tax rate). An arm's length adjustment will raise the transfer price to £150 so that the host country claims back evaded tax. If the ore extraction results in pollution clean-up costs in the host country, these can and should be calculated so that the total adjustment per kilo of ore becomes:

   [(£100 + £50) × tax rate] + externalised cost per kilo.

   Penalties for tax evasion will be added if applicable. A written statement acknowledging the facts and promising compliance would help restore credibility of the TNC and alleviate the psychological harm it caused.
2. If market prices are higher than production costs, there is a (legitimate) financial advantage to the TNC from not charging market-based transfer prices in the host country. However, if Division X controls the pricing decision, it may manipulate a market price (say £200) to its financial advantage by charging it to Division Y or Z when its cost-based price is lower than market price (say £140), thus netting off the difference. The netted difference could be the result of:
   - genuine efficiency improvements, therefore Division X may keep the netted difference. Divisions Y and Z should strive to achieve similar efficiency results;

- abnormally high market prices, for example as a result of industry deregulation; or unauthorised raw materials substitution which can create a chain of problems further down the production line, thus penalising transferee divisions even more after charging them the high market price. The transfer price should be adjusted down by the netted difference of £60 plus any other costs caused to the transferee divisions from using cheap raw materials. A written agreement would help put minds at rest and alleviate some of the psychological harm caused.

The ethics of arm's length legislation and actions of tax authorities

The tough stance adopted by the Internal Revenue Service in the U.S.A. since the late 1980s speaks volumes about the sort of arm's length compliance behaviour required of companies to stop them causing TP financial harm. The OECD guidelines have also prompted governments all over the world to revise their existing legislation or enact new ones to safeguard their national interests. Such is the case in EU countries, Australia, New Zealand, Argentina, Korea and Russia. New legislation has now taken effect in the U.K. for accounting periods ending on or after 1999. The reinforcement and centralisation of the U.K. Inland Revenue's powers to investigate TNCs can only lead to more intensive scrutiny of TP practices. Since 1996, TNCs in France risk fines if they fail to provide specific TP information required by new strict procedures. The importance of TP to the Dutch tax authorities has led to the creation of the *Transfer Pricing Coordination Group* to oversee TP issues as from March 1998. Export enterprises in Kazakhstan suspected of overstating costs and understating revenues in order to hide profits will now face tougher TP legislation (Financial Times, June 1999). These are just few examples of a new "TP world order" which puts the onus on TNCs for unconditional compliance with TP law. In this new order, companies caught in the TP fiddling act have their tax returns revised upwards substantially and penalised with hefty fines, effectively turning "illusory profits booms" into real "cash flow busts". However, not all companies subjected to tax probes manipulate their transfer prices to misrepresent their profits.

The unlimited powers tax authorities have to scrutinise and penalise companies' TP practices may lead to excesses as companies may easily become soft targets for the tax man, especially as there are no financial reporting regulations on TP yet.[13] Even if a company enters into what is called an *advance price agreement* (or APA) there is no guarantee that it will not be investigated for years prior to the APA. Tax probes can catch companies unawares and can be very intrusive and expensive. The financial and other costs to a company can run into $ millions because of lengthy investigations, sentencing, transfer price adjustments, tax back payments and the fines imposed by the tax authority. While the protection of national interests is a legitimate claim, the interpretation and enforcement of an ever changing and complex TP legislation can be uneven and sometimes too prejudiced and machiavellian. For instance, Buckley and Hughes (1998) contend that the arm's length principle is culturally biased against Japanese companies as they have become rather easily suspected of TP fraud. No wonder then that TNCs have in the past contested both the investigation procedures and the penalties imposed on them by tax authorities. Losing the contest to the tax authority has been more the norm than the exception (for example, few years ago Glaxo-Wellcome lost in the High Court to the Inland Revenue over investigation procedures). The U.S. Tax Court ruled in favour of many TNCs (such as Ciba-Geigy in 1985; Baush & Lomb in 1989; and Texaco in 1996) when it became clear that the Commissioners of the Internal Revenue Service abused their authority under rule 482 with arbitrary and unreasonable reallocations of income. Compliance with the new legislation is cause for concern for many TNCs (Elliott, 1998). It is therefore not only legitimate for honest companies to contest the tax man's excesses, but they should also be compensated when victimised. For the sake of fairness, ethical codes and independent arbitration bodies may become a must.[14]

The responsibility of a TNC's home government in TP abuse should also be established when addressing ethics. So far only companies have been the subject of international TP legislation and tax probes. If a resident TNC files abnormally high profits to its home tax authority, it should be apparent to the latter that profits must have been illegally repatriated and that one or more of the TNC's host countries might have lost out through TP abuse. Tax authorities in many countries are now relatively better equipped to detect such anomalies. In an ethical world a tax authority in a TNC's home country should not accept tax income on unearned profits. Instead it should co-operate with tax authorities in the TNC's host country and return the part of the profits which was repatriated through manipulation of transfer prices. External auditors can play an active role in balancing the books as explained below.

Who blows the whistle?

Relying on only tighter legislation which burdens companies with arm's length compliance documentation and makes them vulnerable to lengthy tax probes can in itself push TNCs into new unethical activities. No matter how well equipped tax authorities are, the likelihood that every TNC would be investigated for tax evasion is remote. The main reason for this is that intra-firm trade is mostly subject to internal decisions, not to market forces. Hence, whistleblowing involving divisional managers and external auditors can play a useful preventative or ex-ante role. At the moment, consolidated financial statements do not report intra-firm transactions; only transactions with external parties are shown. When the financial accounts are put into question because of suspected TP misrepresentations and tax evasion, the auditors of those accounts are seldom brought into the limelight, despite their role in checking and validating them. By making TP an integral part of an audit plan, auditors can establish the validity and reliability of a TNC's transfer prices. External auditors of financial accounts should be empowered to blow the whistle if they suspect TP irregularities, thus eliminating the need for lengthy ex-post investigations by tax authorities. This can only happen if there are clear financial reporting guidelines to enable auditors to collect information that could be used as audit evidence of TP practice. In the absence of such guidelines, tax authorities will continue to be the sole auditors of TP accounts.

A TP code of conduct can play a constructive role in self-regulation of intra-firm business by setting standards of perfection against which managers can judge the moral fitness of TP policies and practices. The introduction and gradual implementation of such a code would create awareness by educating managers about TP-related ethics, lead to mutual monitoring, and act as a safeguard against undesirable behaviours. An ethically committed TNC would keep divisional operations under check and also consider the ethics at the TP system design stage to avoid unethical activities from occurring. Recent research shows that ethically committed companies demonstrate better financial performance (see for example Verschoor, 1997). Therefore, proper whistleblowing procedures can stop internal conflict over intra-firm trade and pricing and prevent sub-optimal behaviour and resource wastage but if a company lacks procedures to protect corporate whistleblowers, a TP code of conduct will not work. Power and politics within a TNC may prevent the parties directly involved in intra-firm trade – the transferors and transferees – from blowing any whistles, especially if earnings management is a prime function of the company's TP system. If the company's prevalent ethical climate makes whistleblowing a professional hazard (Badaracco and Webb, 1995), no divisional manager involved in intra-firm trade would whistleblow TP irregularities. Ethical compliance then becomes the sole responsibility of senior management who eventually have to answer to at least tax authorities for TP irregularities when these are uncovered.

Implications for research

The foregoing analyses have highlighted many pertinent ethical issues in intra-firm trade and pricing that future research can address in an empirical setting. In particular, research should examine:

1. The relationship between FDI and intra-firm trade.
2. The externalisation of costs through intra-firm trade and pricing.
3. The extent to which central and subsidiary managers perceive the ethics of intra-firm trade and pricing and the moral reasoning criteria thereof.
4. The extent to which the locus of control in a decentralised TNC influences the perception and reaction to TP harm.
5. How to quantify TP harm and compensate for it in transfer price adjustments.
6. How to formulate TP codes of conduct (e.g. will companies write their own TP ethics textbooks? or will they collaborate with tax authorities?)
7. The personal financial liability of managers when non-compliance results in financial damage to shareholders (e.g. penalties imposed for TP manipulation).
8. How to measure the costs of TP ethics so that priorities can be set and focused actions taken to mitigate/eliminate unethical TP behaviour.

In order to focus on typical intra-firm transactions, the issues raised above are more amenable to case-based research, possibly testing propositions like those suggested below.

Proposition 1: A transfer pricing ethical code gives divisional managers better control of intra-firm activities and reduces dysfunctional behaviour.

Proposition 2: A transfer pricing ethical code is likely to create more positive value for the company and its shareholders and improve financial results, especially when divisional managers have more control over TP decisions.

Proposition 3: Periodic central review of compliance to the ethical code reduces the risk of tax litigation over transfer pricing.

Proposition 4: There will be less costly tax litigation if external auditors blow the transfer pricing whistle during the audit process.

Conclusions

Transfer pricing is a complex management problem and prone to unethical behaviour. This paper helps fill a lacuna in both the business ethics and the transfer pricing literatures and opens avenues for future research on the ethics of intra-firm trade and pricing. Unethical TP behaviour is damaging to both companies and the economies of host governments. Arm's length legislation as currently conceived is not sufficient as it only focuses on international tax revenue collection. Self-regulating codes of conduct are needed to establish the personal responsibility of senior management when non-compliance occurs. However, senior management and corporate credos can be a major stumbling block for establishing sound ethical norms for intra-firm trade and pricing. When TNCs see cross-border intra-firm trade as an opportunity and a means to quick riches and misuse their TP systems to this end, this creates ethical dilemmas for ethically minded divisional managers but who are made ineffectual by corporate dictate. For a TP ethical code to be effective, senior managers must lead by example. External auditors can be empowered to play a decisive whistleblowing role which can minimise the need for lengthy and costly tax investigations and at the same time avoid making companies vulnerable to the possible excesses of tax authorities. Finally, the issues raised in this paper need further study to shed more light on important but under-researched aspects of intra-firm trade and pricing.

Acknowledgements

I am grateful to Chris Cowton, Colin Drury and two anonymous referees for insightful comments on earlier drafts of this paper.

Notes

[1] See for instance Ernst & Young's 1997 *Global Transfer Pricing Survey*. The Bureau of National Affairs in the U.S.A. regularly publishes in *Tax Management: Transfer Pricing* lists of pending TP court cases involving manufacturing companies.

[2] IMF = International Monetary Fund; OECD = Organisation for Economic Co-operation and Development; UNCTAD = United Nations Conference for Trade and Development; WTO = World Trade Organization. The IMF's Balance of Payment Manual (5th ed., 1993) requires countries to show the amounts of intra-firm trade when compiling balance of payment statistics.

[3] U.S. Department of Commerce, Bureau of Economic Analysis and Survey of Current Business, February 1997, pp. 23–28. The U.S.A. is currently the recipient of one fifth of global FDI inflows (UNCTAD, 1998). The *Houston Business Journal* (3 February 1997) estimates that the amount of TP taxes and penalties currently at issue in the U.S. Tax Court exceed $4 billion and that, in the Houston area alone in 1996, investigations of 25 companies resulted in $427 million in additional taxes and penalties.

[4] For recent cases where $millions were recovered in transfer price adjustments and fines, see Financial Times 24/9/1998 and the Morgan Stanley case mentioned in the introduction.

[5] For instance, the British standard on Segmental Reporting (SSAP 25, June 1990) and the U.S.A.'s standard on *Disclosures About Segments of an Enterprise* (FAS 131, June 1997) do not require companies to disclose TP information in their audited annual accounts. The international standard *IAS 27 Consolidated Financial Statements* clearly states that "intra-group balances and transactions and resulting unrealised profits must be eliminated" from financial statements.

[6] See Emmanuel and Mehafdi (1994, 1997) for an extensive review of empirical studies.

[7] The 1994 agreement establishing the WTO unequivocally states in its opening statement that the WTO aims at ". . . expanding the production and trade in goods and services while allowing for the optimal use of the world's resources in accordance with the objective of sustainable development, seeking both to protect and preserve the environment and enhance the means of doing so . . ."

[8] The Institute of Business Ethics (U.K.), the International Business Ethics Institute (U.S.A.) and the Council for Ethics in Economics (U.S.A.) recognise that legislation alone cannot circumvent the ethical issues that global business raises, hence the need for high international industry standards of conduct that promote corporate social responsibility and resource sustainability in the pursuit of economic growth and wealth creation. The 1991 *Federal Sentencing Guidelines* in the U.S.A. and the current *Ethical Trading Initiative* in the U.K. may be seen as positive steps in this direction.

[9] For instance, the Position Paper on *Accounting and Financial Reporting for Environmental Costs and Liabilities* (of the UNCTAD's Working Group of Experts on International Standards of Accounting and Reporting, 1998) recognises externalised costs but defines them as non-absorbed costs that do not affect the financial position and results of TNCs and are therefore ignored. Thus, what seems to matter most and foremost are the financial statements of TNCs. See Schmidheiny (1992) for suggestions on how to account for externalities.

[10] In the U.S.A., the 1977 *Foreign Corrupt Practices Act* which governs the conduct of American TNCs abroad does not extend to intra-firm trade and TP.

[11] See fn. 9.

[12] *Thin capitalisation* can exacerbate these problems when performance evaluation is financially based. Thin capitalisation refers to the practice of playing on corporate tax differentials in host countries by financing the operations of subsidiaries with debt capital from the parent TNC charged via the TP mechanism, resulting in high debt/equity ratios and income shifting. Although the arm's length legislation covers this issue, empirical research is needed to establish the extent to which cost-based transfer prices are affected by notional interest charges.

[13] See fn. 5.

[14] The EU arbitration convention was introduced in 1995 and expires in 1999. In their 8th meeting in 1998, the UN's ad-hoc Group of Experts on International Co-operation in Tax Matters ruled out an international arbitration body, citing organisational and practical difficulties and the apparent ineffectiveness of the EU arbitration convention. This leaves a void in the presence of an ever increasing global intra-firm trade.

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