

## Transfer Pricing and Activity Based Costing: An Integration Between Them

Sayed Farrukh Ahmed\*  
Md. Badruzzaman Bhuiyan\*

**Abstract:** Activity based costing (ABC) is based simply on the premise that businesses must understand the factors that change each major activity and the costs of these activities, and how different activities add values to the firm related to the products in order to run the business effectively and efficiently. The role of transfer pricing policy is to allocate costs within the firm to determine the optimal product mix. The activity based costing approach justifies the transfer prices a multinational corporation uses to transfer unique company services among its divisions located in different countries. This article is an attempt to explain how this approach reduces the probability of costly tax audits and assists in obtaining an advanced pricing agreement. Moreover, this article contrasts the traditional and ABC approaches and shows how the approaches can significantly affect transfer pricing tax liability. Nevertheless, this article provides a glimpse of the potential of ABC in the development of an effective transfer pricing mechanism, one that lowers the risk of a transfer price audit and gives the multinational enterprise (MNE) the flexibility to adjust costs to compete successfully in the global market.

### 1. Introduction

The global imperative propels more companies into the international marketing arena and the challenge of developing effective pricing strategies becomes very complex. Indeed, pricing has been identified as one of the most significant marketing complexities faced by multinational enterprises (Cavusgil, 1996). In dealing with such complexities, marketers have historically relied on accurate accounting information to improve decision making (Kirpalini & Stanley, 2003). These decision complexities are especially evident in situations in which the transfer of intangible services and tangible production inputs among subsidiaries are involved, because these transfers create internal revenues. Such revenues mean that tax authorities will view the supplier of the service or tangible production inputs as a seller and the receiver of such materials as a buyer (Carter & David, 1998), even though the transactions take place between business units of the same company or sister concerns. Thus, internal transfers have pricing and profit implications that require the selling unit to determine an appropriate transfer price to charge the buying unit. Good accounting information is crucial for such decisions.

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\* Lecturers, Faculty of Business & Economics, Daffodil International University, Dhaka.

Determination of the right transfer price is influenced by many factors. Indeed, one study (Burns, 2001) identified ten factors that have a bearing on transfer price determination. Among them were market conditions, economic conditions, competition in the foreign market, exchange and price controls, and differences in income taxes in different countries. The role of taxation is especially important because the involvement of more than one taxing authority frequently means different levels of taxation and different taxation rules in different countries. Failure to satisfy all taxing authorities can have significant consequences. These can include tax audits (which are expensive in themselves) and substantial penalties if irregularities are discovered. In some cases, the result is double taxation; taxes are levied in the jurisdiction of both the seller and the buyer (Fraedrich and Connie, 2001).

Transfer pricing itself is a tool to reduce global corporate tax and indirect business tax. One potential trigger for the penalties is the tendency for some companies to use transfer prices as a means to minimize taxes. This is accomplished by companies pricing in such a manner that profits are higher in countries with lower tax rates and lower in countries where tax rates are higher. For example, a company might set a low transfer price on components or services being sent into a low tax country so that latter sales of finished goods from that country will yield higher profits because of lower taxation. Conversely, a high transfer price would be used in a high tax country so that latter sales would yield lower taxable profits. Such practices of some multinational enterprises (MNEs), as well as the overall increase in transfers among international subsidiaries, have resulted in an increase in government scrutiny and regulation of transfer pricing (Pearson & Dennis, 2001). Furthermore, complying with the diverse policies established by different taxing authorities is very complex. Therefore, companies must carefully consider their approaches to determining and reporting transfer prices.

The typical approaches to transfer price determination have been reviewed and how they may be problematic when transfer pricing involves intra-company movement of unique company services or component parts have been demonstrated. Then how the application of activity based costing (ABC) can be useful in resolving these issues has been shown.

## **2. Transfer Pricing**

Transfer pricing refers to the pricing of goods and services within a multi-divisional organization, particularly in regard to cross-border transactions. For example, goods from the production division may be sold to the marketing division, or goods from a parent company may be sold to a foreign subsidiary, with the choice of the transfer price affecting the division of the total profit among the parts of the company. This has led to the rise of transfer pricing regulations as governments seek to stem the flow of taxation revenue overseas, making the issue one of great importance for multinational enterprises

(Beik and Stephen, 2003). Before 1994, there were essentially some approaches in which transfer prices could be determined to meet the basic arms length standard-the international standard for transfer price determination accepted by tax authorities around the world (Pearson and Dennis, 2001).). The first approach is the comparable/uncontrollable method, which requires the seller to compare its transfer price to that of an independent seller selling a similar good to an independent buyer (Pearson and Dennis, 2001). The second approach is the resale price or gross margin method, which requires the seller to compare its gross profit margin to that attained by independent sellers selling to independent buyers (i.e., comparable uncontrolled transactions). The third approach is the cost-plus or gross markup method, which requires the seller to add a gross profit to product costs that is comparable to that earned by companies performing similar functions (Pearson and Dennis, 2001). Multinational enterprises (MNEs) are required to apply these approaches in a hierarchical fashion; that is, the comparable/uncontrollable resale method is to be used unless the MNE rejects it as unsuitable for its circumstances. The MNE can then try the resale price method, if it is also unsuitable, the cost-plus method can be tried (Pearson and Dennis, 2001).

These approaches were augmented in 1994 by two additional transfer approaches (Beik and Stephen, 2003): the comparable profits method and the profit-split method. The comparable profits method requires the seller to compare its profits to those of similar MNEs. The profit-split method allocates profits between business units on the basis of the functions performed, assets used, and risks assumed by each unit. The profit-split method then compares relative profits with those of uncontrolled MNEs in similar situations. Thus, an MNE can choose from among a total of five transfer pricing options (for a summary of transfer pricing methods, see the Appendix).

Nevertheless, this flexibility is not a panacea because the common theme in each of these pricing methods is a comparison to similar companies supplying similar products to independent buyers (Cooper and Robert, 2001). However, in the case of companies transferring business services or tangible production inputs, it is frequently difficult to identify similar products and services in unrelated companies. This is especially true in the case of tangible production inputs, because the policy of having each subsidiary specialized in its most efficient activity means that many services and tangible production inputs are unique to that subsidiary. Prices of products and services be comparable requires that labor, materials, overhead associated with a given product can be compared with those provided by independent suppliers.

Such comparisons are problematic for MNEs because even if comparable suppliers exist for "work in progress" items or services, it is unlikely that costs would be comparable because of different methods or rates of depreciation, labor and material costs, labor/automation mixes, and overhead bases.

Furthermore, even if information on material and labor costs is obtainable on a comparable basis, data on overhead and indirect costs may be extremely difficult to obtain and even more difficult to compare across services. Nevertheless, the replacement of the strict hierarchical approach with the more flexible best method rule enables an MNE to select the method that best meet the unique needs of the seller, provided that the selection is made in good faith, is properly documented, and generates a reasonable change.

Moreover, the best method for many producers is the cost-plus method because it is already widely used for determining transfer prices in industry (Kim & Eugene, 2004). Yet even as the cost-plus method is being frequently used in transfer pricing, the advent of activity based costing (ABC) is changing the way that indirect costs are allocated in industry. This can have implications in international transfer pricing because using the cost-plus method in combination with ABC offers two potential advantages to MNEs. The first advantage is to provide a rigorous basis for cost allocation, and the second is to generate the specifics needed for an advanced pricing agreement (APA) with taxing authorities. An APA is a negotiated agreement between a company and a taxing authority that determines a transfer price that is acceptable to all parties, using cost and profit information unique to the particular taxpayer. The purpose of the APA is to avoid time consuming and costly tax audits through the careful documentation of costs, which can be provided by ABC.

### **3. Activity Based Costing (ABC)**

Pioneered by Cooper and Kaplan (1988), ABC is a different way of viewing cost allocation. It grew out of the realization that traditional accounting methods are inadequate in providing comprehensive cost information for decision making in today's business environment. This is because the full cost of a manufactured part or service includes direct labor, material, variable overhead, and fixed costs. Direct labor and material are normally observed, measured, and maintained as standards. The overhead costs are reported by responsibility centers, such as departments, plants, or subsidiaries. The difficult decision is how to allocate overhead costs to products or services.

In the traditional approach to cost allocation, the typical business uses a two-step system for absorbing costs. Costs are accumulated in a pool and then allocated to specific goods or services by means of a companywide base such as direct hours and a machine hour used in producing the goods or services (Collins and Michael, 2002). Other allocation bases are machine hours or direct labor cost, for example. The traditional use of direct labor hours as an allocation basis traces back to the mid-1920s, when cost accounting systems were being developed. At that time, labor was a major expense, generating 80% of all costs. Thus, it was a target of management attention. In recent years, however,

direct labor accounts for no more than 8% to 12% of all costs in advanced manufacturing industries (Smith, 2001). Indeed, Kelly (1999) notes that hands-on labor costs in high-technology industries are "closer to 5%, while overhead has ballooned to 55% or more."

Activity-based costing (ABC) responds to the changes in the way costs are incurred in business today by recognizing that virtually all activities taking place within a firm support the production, marketing and delivery of goods and services (Goebel and Greg, 1998). By using ABC, firms can identify systematic cause and effect linkages among products, markets, and costs before resorting to across-the-board allocations. These linkages, called "cost drivers," are activities that cause costs to be "driven" up or down. These costs occur when an activity is performed, so a cost driver is a way of allocating a cost to a particular activity. For example, in marketing, a cost driver may be the number of shipments made to a particular region, number of orders entered, or sales calls made in a region; these drivers are used to allocate costs. In using ABC, firms accumulate costs but then allocate them to goods, services, or regions by the appropriate drivers. For example, a region requiring 15% of sales force time might be charged 15% of total sales overhead; a region using 20% of order entry time would be charged 20% of order entry overhead. Allocating costs in this manner provides an accurate and more complete picture of the costs and profitability of goods or services. As a result, the number of companies using ABC continues to increase. However, ABC does have limitations (Durst, 2002). Some companies find ABC difficult to implement because it requires changes in the way costs are tracked throughout the organization. It also requires the education of employees at all levels about the purposes of and reasons for using ABC. These changes can be costly and time consuming to implement. Furthermore, strong employee resistance as a result of organizational and functional changes required by ABC is the biggest identified obstacle to ABC implementation (Ness, 2001).

#### **4. Activity Based Costing (ABC) and Transfer Pricing**

The advantage of the ABC method is its focus on the allocation of overhead costs. These costs can be substantial when companies transfer components or services between different taxing jurisdictions (Weekly, 2001). Examples of such costs are machine overhead; set-up costs; packing/transportation; research and development (R&D); documentation; site services; warehousing; travel; and sales, advertising, and other costs related to marketing of the finished product. In contrast to the ABC approach, the traditional absorption method reports these activities to responsibility centers and allocates them to products or territories by means of a base of machine hours or direct labor, for example. This approach tends to overstate or understate costs associated with manufacturing component parts or services intended for transfer among company units and could be viewed as arbitrary by taxing authorities. For example, packing or transportation requirements could vary among regions, and their costs could be overstated

in some regions and understated in others. However, using ABC clearly allocates costs to the most appropriate cost driver and removes the arbitrariness. Moreover, using ABC to associate overhead costs with a particular goods, service, or region gives companies some of the needed detail to support APAs between companies and taxing authorities regarding transfer pricing methodologies. As Fallon (2003) notes, the advantage of APAs is that they address transfer pricing issues before administrative examinations or litigation. The result, in cost/benefit terms, is potentially so significant that countries such as Australia, Belgium, Canada, France, Germany, Japan, Korea, Spain, the United Kingdom, the United States, and others are completing APAs (Durst, 2002).

This is not to say that APAs can eliminate all transfer pricing disagreements and disputes, but the costs, uncertainties, and time involved can be greatly reduced. The following section describes how the detail needed for an APA is generated through ABC and compares ABC to traditional costing.

##### **5. Transfer Pricing using Activity Based Costing (ABC): an Illustration**

Tables 1, 2, 3 & 4 provide a theoretical example that shows how ABC affects the allocation of costs and the potential tax liability of a company involved in transfer pricing decisions (Krupnicki and Tyson, 1997). Table 1 provides basic manufacturing (e.g., labor hours, machine hours, direct materials) and marketing (e.g., R&D requirements, order entry, executive salary, corporate advertising) costs that are associated with three different manufacturing locations: one in Asia, one in Latin America, and one in Europe. Direct costs, transfer prices, cost drivers, and overhead costs are shown for each location. The total costs for all three locations are also shown. For example, Table 1 shows that 23,000 units were produced in Asia at a direct material cost of \$16 per unit. This generated \$368,000 of material costs for Asia. Similar calculations for Latin America and Europe yield material costs of \$140,000 and \$150,000, respectively. Thus, total company material costs were \$658,000. Likewise, production and transfer of 23,000 units in Asia required two machine hours per unit, or a total of 46,000 machine hours. Repeating this calculation for Latin America and Europe yielded 71,000 machine hours required to produce total company output of 38,000 units. Totals shown in Table 1 were generated in a similar fashion, and overhead costs and total period costs are also shown in the table.

Basic information has been used from Table 1 to allocate company costs using traditional cost accounting procedures (see Table 2). For example, direct labor per unit produced of \$36 (direct labor at \$12 per hour for three hours) and direct material costs of \$16 are allocated to the Asian location. Next, overhead costs are charged according to the formula shown in notes below Table 2. This yields a total cost of \$115.13 per unit of Asian production, generating total costs of production of the 23,000 units at the Asian location of \$2,648,000. Similar information using traditional costing procedures is shown

for the output from the other two locations, yielding total costs for the three locations of \$3,944,000.

To contrast the traditional cost approach with the proposed ABC approach, Table 3 shows distribution of the same costs using the ABC method. Direct labor and direct materials were allocated as in Table 2, but overhead costs were charged using ABC following the method shown in the notes to Table 3. That is, overhead was allocated by the drivers identified in Table 1. As a result, although total costs charged to the three locations were still the same (\$3,944,000), costs generated by each location changed dramatically, and the results in terms of changes in net revenues in each location are remarkable. These changes are demonstrated in Table 4 in which, for example, it was shown that the revenue generated by the Asian location increased by 346% whereas that generated by the Latin American and European locations decreased by 40% and 305%, respectively. That is, by using traditional costing methods, the Asian location generated net revenue of \$112,000, Latin America generated \$79,000, and Europe generated \$75,000. However, by using ABC to more precisely allocate overhead, the Asian location generated net revenue of \$387,750; this was an increase of \$275,750 (346%). Latin America decreased by \$47,300 to \$31,700 (40%), and the European location decreased

**Table 1: Product Cost Information**

Cost Drivers	Regions			Total
	Asia	Latin America	Europe	
Units produced and transferred	23,000	10,000	5,000	38,000
Direct materials (\$/unit produced)	16.00	14.00	30.00	658,000
Direct labor hours/unit produced	3	2	1	94,000
Machine hours/ unit produced	2	2	1	71,000
Direct labor costs/hour (\$)	12.00	18.00	24.00	1,308,000
Numbers of orders processed	450	100	75	625
Number of set-ups (production runs)	8	4	20	32
Number of R&D requests	7	12	21	40
Warehouse space (square foot/unit)	.75	.5	1.0	27,250
Transfer price (dollars)	120.00	100.00	90.00	4,210,000

<b>Overhead costs (dollars)</b>	
Receiving	61,000
Set-up costs	1,42,000
Machine depreciation	8,90,000
R&D salaries	1,60,000
Order entry	1,00,000
Warehousing	12,000
Packing/transportation	1,48,000
Marketing executive salaries	3,65,000
Corporate advertising	1,00,000
<b>Total</b>	<b><u>1,978,000</u></b>

<b>Total period costs (dollars)</b>	
Materials	6,58,000
Labor	1,308,000
Overhead	1,978,000
<b>Total</b>	<b><u>3,944,000</u></b>

Source: Krupnicki and Tyson, (1997).

net revenue from \$75,000 to \$153,450, a decrease by more than \$228,000 (305%). These changes would be significant in terms of the tax liability associated with intra company transfers. This would be especially true if the reduction in revenue occurred in a high tax location. That is, if either Europe or Latin America was a high tax location, using ABC costing would have a significant impact on reducing tax liability in those locations.

**Table 2: Costing using Traditional Methods (Krupnicki and Tyson, 1997)**

<b>Traditional Unit Costs</b>	<b>Regions</b>			<b>Total</b>
	Asia	Latin America	Europe	
Direct labor (\$)	36.00	36.00	24.00	
Direct materials costs (\$)	16.00	14.00	30.00	
Overhead (\$) <sup>a</sup>	63.13	42.09	21.04	
Cost per unit (\$)	115.13	92.09	75.04	
<b>Total costs</b>	<b>\$2,648,000</b>	<b>\$921,000</b>	<b>\$375,000</b>	<b>\$3,944,000</b>



<sup>a</sup>Total overhead (\$1,978,000)/total direct labor hours (94,000) = \$21.043 per direct labor hour:  
 Asia = three hours at \$21.043 = \$ 63.13, Latin America= two hours at \$21.043= \$42.09 and  
 Europe = one hour at 21.043 = \$ 21.04

**Table 3: Costing using the ABC Method (Notes: See Table 1 for detailed cost data)**

	Regions			Total
	Asia	Latin America	Europe	
Direct labor	36.00	36.00	24.00	1,308,000
Direct materials	16.00	14.00	30.00	658,000
Set-up costs	1.54	1.78	17.75	1,42,000
Machine depreciation <sup>a</sup>	25.08	25.08	12.54	8,90,000
R&D salaries	1.22	4.80	16.80	1,60,000
Receiving	1.91	.98	1.46	61,000
Order entry	3.13	1.60	2.40	1,00,000
Warehousing <sup>b</sup>	.33	.22	.44	12,000
Packing/transportation <sup>c</sup>	3.90	3.90	3.90	1,48,000
Marketing executive salaries	11.43	5.84	8.76	3,65,000
Corporate advertising <sup>d</sup>	2.63	2.63	2.63	1,00,000
Cost per unit (\$)	103.17	96.83	120.68	
<b>Total costs (\$)</b>	<u>2,373,000</u>	<u>968,000</u>	<u>603,000</u>	<u>3,944,000</u>

<sup>a</sup>Machine hours x machine overhead rate (\$890,000/71,000hrs) = 12.54. <sup>b</sup>Total warehousing cost of \$12,000 for 27,250 square feet = \$.44/sq. ft. <sup>c</sup>Total packing/transportation cost of \$148,200 for 38,000 units = \$3.90 per unit. <sup>d</sup>Total corporate advertising cost of \$100,000 for 38,000 units = \$2.63 per unit.

Source: Krupnicki and Tyson, (1997).

**Table 4: Cost comparison: traditional vs. ABC costing (Krupnicki and Tyson, 1997)**

Traditional Unit Costs	Regions			Total
	Asia	Latin America	Europe	
Transfer revenue	2,760,000	1,000,000	4,50,000	4,210,000
Cost of goods	1,196,000	500,000	270,000	1,966,000
<b>Gross revenue</b>	<b>1,564,000</b>	<b>500,000</b>	<b>180,000</b>	<b>2,244,000</b>
Less Overhead Expenses				
Receiving				61,000
Set-up costs				1,42,000
Machine depreciation				8,90,000
R&D salaries				1,60,000
Order entry				1,00,000
Warehousing				12,000
Packing/transportation				1,48,000
Marketing executive salaries				3,65,000
Corporate advertising				1,00,000
<b>Total Overhead</b>	<b>1,452,000</b>	<b>421,000</b>	<b>105,000</b>	<b>1,978,000</b>
<b>New Revenue</b>	<b>112,000</b>	<b>79,000</b>	<b>75,000</b>	<b>266,000</b>

**ABC Costing**

Transfer revenue	2,760,000	1,000,000	4,50,000	4,210,000
Cost of goods	1,196,000	500,000	270,000	1,966,000
<b>Gross revenue</b>	<b>1,564,000</b>	<b>500,000</b>	<b>180,000</b>	<b>2,244,000</b>
Set-up costs	35,450	17,800	88,750	1,42,000
Machine depreciation	576,500	250,800	62,700	8,90,000
R&D salaries	28,000	48,000	84,000	1,60,000
Receiving	43,900	9,800	7,300	61,000
Order entry	72,000	16,000	12,000	1,00,000
Warehousing	7,600	2,200	2,200	12,000
Packing/transportation	89,500	39,000	19,500	1,48,000
Marketing executive salaries	262,800	58,400	43,800	3,65,000
Corporate advertising	60,500	26,300	13,200	1,00,000
<b>Total Overhead</b>	<b>1,176,250</b>	<b>468,300</b>	<b>333,450</b>	<b>1,978,000</b>
<b>New Revenue</b>	<b>387,750</b>	<b>31,700</b>	<b>(153,450)</b>	<b>266,000</b>

## 6. Conclusion

More companies seek growth opportunities through international competition and many will face the issue of pricing of component parts among subsidiaries. Such pricing situations can present potential problems if the issue of transfer price taxation is not addressed properly.

Furthermore, many companies view cost-plus pricing as an effective way to provide necessary detail in a tax authority acceptable framework. However, ABC, a procedure that more accurately reflects the way that costs are generated in contemporary industry and reduces much of the arbitrariness associated with the traditional approach to costing, is increasingly supplanting traditional cost-plus pricing.

This article contrasts the traditional and ABC approaches and shows how the approaches can significantly affect transfer pricing tax liability. It also demonstrates the detailed information generated by ABC that could provide the documentation needed for an APA, which would significantly reduce the risk of a costly tax audit. This approach makes it possible to justify the overhead costs associated with the transfer of unique components and services among the divisions of an MNE. Furthermore, it provides the rationale for differences in transfer prices that occur among divisions operating in different countries. This flexibility allows the MNE to adjust costs and prices to cope with country-specific conditions. Whether ABC or traditional costing is the most appropriate method for a particular company depends on many factors, only one of which is potential for negative tax consequences. Further research to examine the relationship between ABC and transfer pricing would be useful. For example, empirical studies on MNEs using ABC in conjunction with APAs can be undertaken. Case studies can be carried out to explore the effectiveness of ABC in reducing tax audits. Other studies can examine the impact of ABC beyond transfer pricing, for example, in relation to other issues in international marketing, such as relative profitability of product lines or alternative marketing strategies. Nevertheless, for those concerned with transfer pricing issues, this article provides a glimpse of the potential of ABC in the development of an effective transfer pricing mechanism, one that lowers the risk of a transfer price audit and gives the MNE the flexibility to adjust costs to compete successfully in the global market.

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### **Appendix**

Transfer Pricing Methods (Pearson and Dennis, 2001):

1. Comparable uncontrolled price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction.
2. Resale price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. The resale price method measures the value of functions performed and is ordinarily used in cases involving the purchase and resale of tangible property in which the reseller has not added substantial value to the tangible goods by altering them before resale.
3. Cash plus method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. The cost-plus method is ordinarily used in cases involving the manufacture, assembly, or other production of goods that are sold to related parties.
4. Comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length on the basis of objective measures of profitability derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.
5. Profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss.