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Factors Influencing the Selection of Methods and Determination of Transfer Pricing in Multinational Companies: A Case Study of United Kingdom

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ABSTRACT: One of the main problems of multinational companies occurs while determining the transfer pricing methodology on transfer pricing. Nevertheless, there are many different factors that influence the transfer prices. These factors can be classified as legal, political, internal and external factors. In this study, starting with the most significant point which can be called as the definition of transfer pricing, methodology of transfer pricing and the factors that affect the determination of transfer prices are investigated briefly. Besides the British application on transfer pricing, legal procedures and the studies with relevant application are reported with their results.

Keyword: Transfer Pricing; United Kingdom; Multinational Companies
JEL Classifications: M41; M16

1. Introduction

The significance of multinational corporations in world trade accompanied by the surge in international trade has been increasing. Those corporations which operate in more than one country have been encountering various difficulties. One of those difficulties emerges in the determination of transfer pricing or in the selection of transfer pricing methods. Upon further review of related literature, some factors appear to be gaining prominence in determination of transfer pricing levels.

Those factors are classified as of organizational, environmental and financial structure according to some authors; and of legal, economic, political and social strucure according to some other authors. Such factors should be analyzed by corporations thoroughly. Because these factors can affect determination of transfer prices and selection of methods.

In this study, besides the definition and importance of transfer pricing and the factors that affect determination of transfer prices and selection of methods, related legal regulations, research studies and applicable methods in United Kingdom are investigated.

2. Definition and Importance of Transfer Pricing

Transfer pricing can be used for goods and services transferred between units or profit centres within the same firm, as well as for goods and services transferred between related companies located in different countries (Li, 2005: 59). Transfer pricing, in general, is defined as a term used in order to represent the value of transactions among the subsidiaries operating in different countries (Günaydın, 1999: 166). In other words, transfer pricing is defined as the price charged for transferring a corporation's tangible and intangible assets, goods or services, raw materials, know-how and technology to its subsidiaries or branches (Heimert, 1997: 12; Aranoff, 2000: 3; Davidmann, 1996; Doğan, 2003: 80; Doğan, 2004: 71).

Since the accurate determination of prices of the transferred assets in compliance with the corporation's goals is critically important, in this part of the study; the details of transfer pricing for goods and services transferred among a corporation's units and among multinational corporations will be emphisized.

Following are the reasons for importance of transfer pricing in goods and services transferred between the units of a corporation (Johri ve Charko, 1990: 12-17; Çelik, 2000: 104-105):

- It can be used to increase the autonomy of each unit of the corporation. This autonomy should not be misinterpreted as absolute independence; it rather means that management of each unit is entitled to make decisions pertaining to its own unit.
- It can provide a means to evaluate and to compare the performance of different units.
- It can be used to motivate managers to maximize revenues and profits.
- It can be used as a tool in order to maintain goal congruence between a service unit and the whole organization. In a sense, it helps to coordinate unit's decisions for achieving corporation's goals. Otherwise, it possibly leads to a conflict between unit managers and upper management.
- It provides the units with the opportunity to compare between different options regarding sales and purchasing decisions.

The importance of transfer pricing in goods or services transfers of multinational corporations are as follows (Cooper, 2000: 13-15; Dicle, 1995: 33-34; Dunning, 1993: 516-517; Kutay, 1996: 122; Kim and Swinnerton, 1997: 17):

- Multinational corporations may minimize negative effects incurred by inflation, exchange rate fluctuations and restrictions by utilizing transfer pricing. In addition, multinational corporations may even disrupt the entry of their competitors to the market by exhibiting poor financial performance deliberately with the help of transfer pricing.
- Transfer pricing has utmost importance in production, marketing and financing strategies of multinational corporations by influencing their long-run objectives. Because, transfer prices at the investments of multinational corporations in developing countries and expected returns on investments in foreign countries are closely related to each other. Therefore, transfer pricing practices are important for multinational corporations.
- Multinational corporations regard transfer pricing as a tool for attaining their objectives related to various activities such as taxation. Because, those corporations may lower the tax level to be paid in global scale simply by keeping transfer prices lower or higher in goods or services transfers of their susidiaries. Sometimes multinational corporations do not pay any tax at all by virtue of such practice. Those tax amounts they do not pay reach very high levels. For instance, the tax loss caused by transfer pricing in the United States in 1992 is reported as $28.7 billion by Zdanowics and Pak. Furthermore, according to statistics of the Internal Revenue Service (IRS) in the United States, 15 % false declared transfer prices led to $13 billion revenue loss of U.S. Treasury. Nonetheless, according to Vaitsos' study for Colombia, this country's annual tax loss amounted to $10 million as transfer prices changed 26 % in chemical industry and 155 % in pharmaceutical industry. This is the reason for some governments to apply legal regulations, restrictions and penalties on transfer pricing.

Governments often realize the importance of transfer pricing by considering it as one of the most prominent political issues.

- Due to malpractice of transfer prices, the revenue services in many countries tend to be susceptible on the matter by promoting transfer price analysis. Moreover, revenue services in different countries began to constitute a better exchange of information.
- Those revenue services are provided with new tools for obtaining information and punishing misconducts.
- Increasing rate of high technology goods in world trade also enhances the importance of transfer princing. Because, it becomes difficult to determine the just price as well as the price to be compared in the transfer of high technology goods. Thus, determination of prices for the transfers in multinational corporations and selection of applicable methods must be meticulously chosen.

3. Applicable Transfer Pricing Methods

Due to problems in determination of transfer prices and selection of transfer pricing methods and double taxation created by transfer pricing in countries, OECD (Organization for Economic Cooperation and Development) has created International Transfer Pricing Guidelines. These guidelines basically cover the application of the arm's length principle in assessment of transfer pricing of subsidiaries. The guidelines aim to render assistance to taxation offices and multinational corporations located in either OECD-member or non-member countries by eliminating possible contradiction problems in transfer pricing.

Moreover, these guidelines also describe such methods that would be applicable in assessment of multinational corporations' internal commercial and financial transactions within the arm's length principle (Soydan, 1996: 106). The price or remuneration compliant with the arm's length principle is defined as the market price determined at the instant of the transaction merely by unrelated individuals without the ability to influence such price or remuneration whatsoever (5520 VUK).

Such determined price or remuneration, being the most convenient amount determined objectively without any influence, is expected to be the exact price or remuneration charged for the transactions among the related individuals.

Following are the list of methods mentioned in OECD Guidelines (OECD, 2010: 2-16; Kratzer, 2008: 3-4: Gelir İdaresi Başkanlığı, 2010: 68; Transfer Fiyatlandırması Yoluyla Örtülü Kazanç Dağıtımı Hakkında Genel Tebliği Seri No: 1);

- **Comparable uncontrolled price method;** defines a mechanism where the sales price compliant with the arm's length principle charged by a corporation is determined by comparison with the market price changed at transactions among unrelated natural persons or legal entities. In order for this method to be applicable, characteristics of the transactions among related individuals must be comparable with characteristics of the transactions among unrelated individuals. This concept of comparable characteristics here refers to similarity between the characteristics of transactions among related individuals and transactions among unrelated individuals on exchange of goods and services in question. In case of small measurable discrepancies between those transactions, the method would be applicable upon elimination of those discrepancies. However, in case of larger discrepancies, the method would not be applicable. This is the most frequently used method for comparable uncontrolled transactions by virtue of its feature of direct comparison.
- **Resale price method;** refers to estimation of the price compliant with the arm's length principle by deducing an appropriate gross sales profit from the price to be charged for resale of goods and services to unrelated natural persons or legal entities. The essential element for reaching the price or remuneration compliant with the arm's length principle in this method is the price or remuneration to be charged for the potential sale to unrelated natural persons or legal entities.

  The price compliant with the arm's length principle to be charged for related transaction would be reached by deducing an appropriate gross sales profit from the price or remuneration based on assumptions. The appropriate gross sales profit here refers to a profit determined according to market conditions by an objective percentage which would be applicable at the instant of transaction pertaining to goods or services in question. After deducing this profit amount, the price compliant with the arm's length principle to be charged at the sale of goods or services to related individuals would be determined.
- **Cost-plus method;** is defined as estimation of the price compliant with the arm's length principle by increasing the cost amount of related goods or services up to an appropriate gross profit rate. The appropriate gross profit rate here refers to the profit rate reflecting the price to be charged for the sale of goods or services to unrelated individuals. Under favourable conditions, the general gross profit margin applied for transactions of goods or services to unrelated individuals would be perceived as an ideal rate. In case of insufficient number of transactions for comparison, the criterion for an appropriate gross profit would be considered as the profit rate reflecting the price to be charged for the sale of goods or services in question to unrelated individuals. This method is mostly used especially in transactions involving the goods manufactured by raw materials and intermediate goods.

- **Transactional net margin method;** is based on the analysis of net profit margin determined by an appropriate basis such as costs, sales or assets in a controlled transaction.
- **Profit-split method;** being based on the principle of distribution of total operating profit or loss pertaining to one or more controlled transactions among the related individuals commensurate with the assumed functions and the burdened risks within the arm's length principle, is applicable especially when transactions are intertwined.
- **Other methods.**

Nonetheless, there are many other applicable methods for determination of transfer prices besides the ones mentioned above. Those methods are classified as market-based and nonmarket-based methods by some authors (Jamal, Saleh and Karima, 2008: 315-316; Al-Eryani and Alam, 1990: 409), while some other authors classified them as cost based, market price, linear programming, negotiated, profit sharing-based (Williamson, 1996: 655) and dual transfer pricing methods (Pass, 1994: 44-47; Johri and Charko, 1990: 12-17).

4. Factors That Influence Determination of Transfer Prices and Method Choice

Transfer pricing is also used as a strategic tool by multinational corporations in decision-making (Heimert, 1997: 12), for realization of core activitiy goals and tax minimization (Cooper, 2000:13-16) and for profit maximization of their subsidiaries which operate in countries with lower tax rates (Fraedrich and Bateman, 1996: 17). Because, transfer prices determined in goods and services transfers and the applicable methods used to determine those prices are crucial for achieving such goals.

Therefore, either parent corporations or subsidiaries must consider such factors that influence those prices in determining transfer prices. The factors that affect determination of transfer prices and selection of methods in terms of parent corporations and subsidiaries are separated into four groups;

Legal factors,

Political and social factors,

External economic factors,

Internal economic factors.

Following are the components of those factors (Lin and Chang, 2009: 1216-1219; Jamal, Saleh and Karima, 2008: 314; Li, 2005: 62-63; Chan and Lo, 2004: 94; Doğan, 2003: 66-67; Doğan and Çürük, 2003: 28-30; Al-Eryani and Alam, 1990: 409-426; Elliott, 1998: 48-51; Choi and Mueller, 1992: 535).

1- Legal Factors;

- Tax rates and tax laws in the country in which the parent corporation operates,
- Tax-customs laws and rates in the country in which the subsidiary operates,
- Government interventions (price and quantity restrictions),
- Shares of the local partnerships,
- Principles of tax authorities,
- Financial reporting standards,
- Anti-dumping and anti-trust laws in the country in which the corporation operates.

2- Political and Social Factors;

- Confiscation and dispossession risks in the country in which the corporations operate,
- The corporations' ability to have well connections with the government of the country in which they operate,
- Racist policies in the country in which the corporations operate,
- Civil warfare in the country in which the corporations operate,
- Religious conflicts in the country in which the corporations operate,
- Political instability in the country in which the corporations operate,
- Human rights violations in the country in which the corporations operate.

3- External Economic Factors;

- Exchange rate controls and exchange rate fluctuations,
- Restricitons on profit and cash transfers,
- Price controls,

- Import restricitions and quotas,
- Inflation rates in the countries in which the corporations operate.

4- Internal Economic Factors;

- Market shares of corporations,
- Market structure of the countries in which the corporations operate.
- Competitiveness of the corporations,
- Performance and evaluation criteria for the corporations.

In addition to the components shown above, some authors has classified the factors that affect determination of transfer prices and selection of methods such as; organizational, environmental and financial factors (Borkowski, 1997: 25-48). Besides those factors, size of the corporation and the share of sales to parent corporations and their subsidiaries in total sales are also known to have influence on determination of transfer prices and selection of methods. For example, a study has indicated that big corporations utilize the market-based transfer pricing method for determining transfer prices (Al-Eryani and Alam, 1990: 409-426). Nevertheless, degree of development in the country in which multinational corporations operate also influences determination of transfer prices and selection of methods. In summary, the selected transfer pricing method may depend on a country's degree of development.

5. Studies on Transfer Pricing in the United Kingdom (UK)

Although the term "transfer pricing" was first coined in 1883, by the year 1920 it became popular especialy in the areas of accounting and management (Cox and Howe, 1997: 20). In this part of the study; the information on regulations, research studies and methods applied only in the UK will be given.

Harry Sidgwick's book "The Principles of Political Economy" published in 1901 is considered as the first publication indirectly related to transfer pricing. In his book, the author stated that the corporations which employ their own products in the process of production should assume the market price at which they process the transactions for those products (Kapusuzoğlu, 1998: 56-57).

In 1970s, many studies were published on economical approach which gained predominance within management accounting. In those publications, the majority of the authors aimed to define transfer princin in terms of cultural diversity and activities. In that era, Inland Revenue in the UK and Internal Revenue Service in the USA (IRS) have developed precautions against fraudulent acts and tax evasion on transfer princing.

According to related studies published until 1990 on transfer pricing applications have indicated that most of the US.-based, Japanese and theUK multinational corporations and have utilized cost-based method and the Canadian corporations have used the market-based method in transfer pricing (Horngren, 1991: 866).

In 1998 in the UK, a research study was sponsored by CIMA and Deloitte & Touche in order to give more information on approaches on transfer pricing in both UK-based and foreign-based corporations (Elliott, 1998: 48).

According to the results of a questionnaire study by Roger Tang, 92% of the U.S.-based multinational corporations, 73% of the Japanese corporations, 85% of the Canadian corporations and 79% of the UK corporations have cleary stated that they benefited from changing their transfer prices (Borkowski, 1997: 25-48; CPA Journal, 2000: 10; Cravens, 1997: 133; Sherman and McBride, 1995: 29; Dicle, 1995: 34-35).

One of the corporate-based reaserch studies related to Sony Corporation revealed the fact that Sony Corporation did not pay any taxes in the UK and during 1980s.

On the other hand, another research study was made in the UK for banks and long-term credit lenders to real estates buyers (building societies). The aim of this study was to detect transfer pricing methods used by those institutions. According to the results of this research study, 57% of those institutions utilized the market-based transfer pricing method (Oyelere and Turner, 2000: 93-99).

A study on transfer pricing methods of manufacturing companies by Drury, Braund and Osborne revealed the following results below (Atril and Mclaney, 2007: 373):

Used Methods	%
Variable Cost Method	37
Full Cost Method	42
Variable Cost + Profit Margin Method	30
Full Cost+ Profit Margin Method	52
Market Price Based Method	52
Negotiated Method	70
Other Methods	9

In 2003, another study on British corporations in global scale has revealed the following results below (http://business.highbeam.com/409711/article-1G1-135379056/ transfer- pricing- 2003-g.. 18.07.2012);

- 92 % of the parent corporations believe that transfer pricing is still important for their group,
- 96 % of the subsidiaries believe that transfer pricing is still important for their group,
- 40 % of the parent corporations believe that achieving management/operational objectives has a greater influence on determination of transfer prices than fulfilling tax requirements,
- 68% of the parent corporations believe that compliance with the related guidelines/instructions is being strictly monitored,
- 68% of the parent corporations believe that transfer pricing documentation is even more important now than compared to two years ago,
- 66% of the parent corporations believe that transfer pricing is of a major international tax issue,
- 68% of the subsidiaries believe that transfer pricing will be of the most important international tax issue in the future,
- 84% of the subsidiaries report the related documents of transfer pricing in accordance with tax laws of the countries in which they oerate,
- 72% of the subsidiaries believe that an examination/auditing activity on transfer princing would be performed within the next two years,
- 82% of the parent corporations believe the possibility of an auditing activity on transfer princing to be performed within the next two years,
- 82% of the parent corporations believe that the transactions of services transferred among the corporations will still one of the most important transactions in the future,
- 72% of the parent corporations state that they will utilize transfer pricing as a part of their management strategy,
- 38% of the parent corporations report that, in order to determine the price compliant with the arm's length principle to be charged for the sale or transfer of tangible assets, they apply cost plus method.
- 42% of the parent corporations report that, in order to determine the price compliant with the arm's length principle to be charge for the sale or transfer of services, they apply cost plus method,
- 32% of the parent corporations report that, in order to determine the price compliant with the arm's length principle to be charged for the sale or transfer of intangible goods, they apply other methods.

The law pertaining to transfer pricing in the UK originates from a regulation dated back in 1915. This regulation was revised in 1951 and in 1998 (Buzzacott, 2012: 1). The highest authority in the UK according to this regulation of transfer pricing is Inland Revenue. The legislation in Schedule 28AA ICTA 1988 commits itself to interpreting transfer pricing transactions in line with the principles of the OECD. In addition, Inland Revenue has issued Data Bulletin 25, 38, 44 and 46 on transfer pricing (Tondkar, Achilles and Smith, 2005: 204).

The arm's length principle test is accepted as the key requirement. According to the regulations, a penalty situation arises if there is an inaccuracy in the documents. Depending on the cause of the inaccuracy (careless, deliberate, or deliberate and concealed) UK Transfer Pricing Penalties are listed below in percentage of potential lost revenue (KPMG, 2012; Almand, 2011);

- If the inaccuracy is due to carelessness, 30% of potential lost revenue,
- If the inaccuracy is deliberate and not concealed, 70% of potential lost revenue,
- If the inaccuracy is deliberate and concealed, 100% of potential lost revenue.

The UK fundamentally follows the OECD lead on transfer pricing for goods and services transfer transactions. Therefore, The UK legislation is being updated in order to reflect the revised OECD Guidelines in 2010. As a result of this revision, applicable transfer pricing methods are as follows below (KPMG, 2012, Almand, 2011);

- Comparable uncontrolled price method,
- Resale price method,
- Cost plus method,
- Transactional net margin method,
- Profit-split method.

In a study on the methods listed above, it is detected that the authorities especially in the UK followed the OECD Guidelines and established less detail-oriented regulations on transfer pricing issue than for example, the U.S. Government (Tondkar, Achilles and Smith, 2005: 213-214).

6. Conclusion

Although several methods are utilized for estimating transfer prices, it is clearly seen that there are many factors affecting determination of those prices and selection of methods. A questionnaire method is used in order to detect how those factors affect determination of transfer prices and selection of methods. Various studies have not established a concensus on different factors. The future studies should aim to detect those factors by the instrument of published financial reports of multinational corporations.

The transfer pricing methods used by those corporations must be referred to a footnote in their financial reports. Thus, some factors that affect selection of transfer pricing methods would be objectively detected with the help of those financial reports. However, the studies on detection of whether or not a relationship between transfer pricing methods and such variables as sales of the corporation, corporation's profitability, the sector in which it operates, its asset structure and its size are also crucial for the solution of related problems. Some related revisions for International Financial Reporting Standards would be beneficial in order for further studies on this issue to be carried out.

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5520 Sayılı Kurumlar Vergisi Kanun