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Transfer Pricing and its Effect on Financial Reporting: A Theoretical Analysis of Global Tax in Multinational Companies

[1]Hassnain Raghib Talab, [2]Hakeem Hammood Flayyih and [3]Yassir Nori Mohammed Yassir
[1]Department of Accounting, Economic and Administrative College, Kufa University, Kufa, Iraq
[2]Department of Banking and Finance, Economic and Administrative College,
University of Baghdad, Baghdad, Iraq
[3]AFF/Presidency of University of Baghdad, Noor Abbas Hussein, Baghdad, Iraq

Abstract: The purpose of the study is to explore and analyse the influence of transfer pricing on financial reporting in global tax from a theoretical point of view. Prior literature was used to develop a construct indicating the degree of focus on the concepts of transfer pricing, the modern way of transfer pricing way, the purpose of transfer pricing, the most common transfer pricing methods, determination and clarification as regards transfer pricing issues, the rules of transfer pricing and its future consequence and an overview transfer pricing in some selected countries. The results from literature review and an analysis of global tax in MNES show that some rules of transfer pricing as recommended by OECD provide the next conditions that a transaction must meet to fall below the transfer pricing principles. Multinational organizations can be of a very planned advantage by having a parent company (the head office) and venture/associates or subsidiaries operating in other countries/locations as a consolidated entity which linked companies (head offices and its associate/joint/a subsidiary) taking its activities in different states/nations. Given the exploratory nature of the research reported in this paper, there is an opportunity for further work on larger populations instead of reducing the scope to four countries (Australia, India, Malaysia and Kazakhstan) in order to confirm the generalizability of the findings. Also, this research has highlighted an association between the transfer pricing, financial reporting, global tax in MNEs and this requires further investigation in terms of confirming suggested cause and effect relationships. The existence of cross-border transactions in transfer pricing, the transaction takes place between two associated MNEs will be a subject of goods, services or any other thing with economic value. The existence of a link between a transfer pricing and financial reporting provides a potential route for making effective corporate policy on global tax for those looking to improve organizational performance through placing a greater emphasis on satisfying the MNEs. The absence of a link between transfer pricing and corporate tax incentives of transfer pricing reveals that manipulation in transfer price will minimize profits through sites worldwide. Transactions resulting from taxes and customs duties to provide an opportunity for multinational corporations may increase the liability of tax. The exploratory research in this study and panel study focuses on the link between transfer pricing and an area of global practices, namely, corporate tax in Multinational companies that has received limited attention in prior studies.

Key words: Transfer pricing, financial reporting, tax, corporate policy, multinational companies

INTRODUCTION

From the last 5 year, most important issue of transfer pricing to the boarder issue business audience. However, transfer pricing is very serious issue not only important for the management but also management of national taxes. In now days working environment, companies want to achieve the main objective financial or non-financial to use transfer pricing. Role of transfer pricing prominence on internationally transaction when two companies performing transaction fixed price, allowing in particular the achievement of precise objectives. Internationally related companies can use transfer pricing to shifting profits from one company to another to achieve profits tax benefits and maximize the combined profits or to enter new markets and increase its share in the market

Corresponding Author: Hassnain Raghib Talab, Department of Accounting, Economic and Administrative College, Kufa University, Kufa, Iraq

current. Transfer price influence on the taxes which is most vital for management of the national tax (Allen, 1999). The transfer price considers the price established when one part of an organization provides tangible and intangible goods to another part of the same organization in two or more countries. Overall this strategy is widely used by multinational organizations as a way to reduce tax liability. Organizations recognize most of the profits in countries with low tax rates which reduces the tax burden on the organization as a whol (Adams and Drtina, 2010). Main contribution of this study to identify some perception into transfer pricing.

Background of the study: According to Terzioglu (2016) defined that "transfer price as a charge by one division (transferring division) to another division (receiving division) within the same organization". Further, transfer price accrue between two organization or parties (e.g., a parent company and its controlled foreign corporation) in an inter-company transaction. Though inter-company transaction is eradicated when combining the financial result of controlled foreign corporation and their domestic parent, for tax determination such entities are not combined and their transactions are therefore not eradicated (Terzioglus, 2016). According to Matei and Pirvu (2011) described term of transfer pricing as price transfer between two companies or organization which agree on the purchase and sale tangible goods and intangible items or services as financial, administration, leasing, etc. Transfer pricing is set at the transnational corporate decision-making structures and can perform the following role:

- Reduction in corporate income tax payments or duties
- Transferring income from countries with bans or limitations on profit repatriation

The corporate policy regarding transfer pricing is based on many factors such as:

- Fiscal aspects of countries involved in the cross-border activity of member companies of the group
- Currency legislation
- Political and economic risks (for example, legislative changes, currency devaluation, etc)
- Price level in the host country, etc

Commonly, transfer pricing is consider that price of goods and service already sold between both parties to focus on tax: companies considers reduction of tax on company profit. With process of increasing and decreasing transaction between groups, companies decision maker/or mangers fix the most of benefit in the most permissive tax jurisdictions (Matei and Pirvu, 2011). According to Lai *et al*. (2013) that transfer pricing is a mechanism used by MNEs to price goods and services transferred between related companies in two or more countries. As transfer is made between related companies, the pricing may not reflect an arm's length price as such cross border transactions are not subject to the same market forces as those made between independent parties (Lai *et al*., 2013).

Further, Gupta (2012) described that transfer prices as belonging to enterprise transfer intangible and tangible item or deliver the services to related company. Moreover, Gupta (2012) economic corporation development provide the transfer pricing hand book or guidelines to organization to understand the further Williamson defined that transfer pricing as "payment from one part of a multinational enterprise for goods or services" multinational companies is not feel comfortable from this definition. Which focus only on the one third of the cross-border sale of goods and services all over the world ensues between associated enterprises of MNCs. Another researcher defined transfer pricing as McKinley and Owsley that transfer pricing is the price transaction between related parties (such as a parent company and its foreign control) in an in a joint venture transaction. However, the contract between two organizations are eradicated to increase the financial income of controlled foreign company by domestic parent, it is not main purposes to consolidation of these entities and are therefore not eradicate their transactions.

Literature review

Transfer pricing in the modern era: In the modern era transfer price defined as price paid between two companies for items, goods and services delivered or many companies as member of consolidation group itself. In simple words transfer pricing is price paid between two companie's transaction on any service and goods. Influence of the transfer pricing specifically impose the stress on companies which involved in the registered in the same group. Parent company and its subsidiaries include everything. Usually when a company has established a subsidiary relationship (acquirer) acquires over 50% of voting outstanding stocks of another company (acquired company). Therefore, acquirer obtains control over operating and financial policies of acquired

companies. But the parent subsidiary relationship may be established when acquirer acquires <50% of voting outstanding stocks if the agreement between the acquirer and acquired company enables the acquire the control over acquired company and its operating and financial policies. For example, according to the Parent-Subsidiary Directive (EU) 10% is sufficient for establishing a parent the relationship between the two companies affiliate.

When transfer pricing accrue range should be used as tool transfer profit to one company another with in same group or vise varse (Gulin, 2005). Furthermore, charges of transfer pricing effects on the profitability of companies related to same group. Thus, business managers involved in transfer pricing policy of the group. But transfer pricing is specially emphasized in multinational groups. When the members of the group are from different countries with different tax systems. Overall, transfer prices in the group can be used to make profits of companies within the group in the country with the least tax burden.

Purpose of transfer pricing: Transfer pricing has several objectives, according to Pereeviac, there are some primary objectives as follow: transfer pricing in the function of maximizing consolidated profits and minimizing tax liabilities: transfer prices used in companies operating in different location like multinational companies to avoide high amount of tax in a particular country. Multinational organizations can be a very planned advantage of having a parent company (the head office) and venture/associates or subsidiaries operating in other countries/locations as a consolidated entity which linked companies (head offices and its associate/joint/a subsidiary (ies) taking its activities in different states/nations. The only distinction is that some subsidiaries are mainly profit oriented and speculation are not full integrated and autonomous authorized entity related to it. So, the companies operation in different countries may use the opportunity and weakness of income tax systems other nations, by appling transfer pricing as a means for moving consolidated earnings in the income tax system of a nation that has less tax burden. The companies apply this method of avoinding high tax burden in the following way: transfer prices used toreduce revenues from similar entities (associates/subsidiaries) working in unfavorable tax environment and increasing the revenuewhich is associated entities/enterprise which undertakes its activities in encouraging income tax setting. The outcome of this is that it will improve incomes by reducing taxe. Exploitation that works or used in transfer prices by the international business enterprises can be understood as: associated entities/enterprise which pertake their operations in adverse tax setting are paying least transfer prices in dealings with associated subsidiaries as compared to those operate in encouraging tax setting, however while apparent or subsidiaries that has encouraging tax environment charge high transfer prices in dealings with allied entities in harsh tax environment. For the to gain, the multinational companies will reduce the revenues of subsidiary/a parent company (ies) that are in adverse tax setting while revenue of associated enterprise, i.e., either the parent or its subsidiary (ies) in encouraging tax setting are maximized. The outcome is a tax burden less the standardized and high-income group-wide (Abazajian *et al*., 2009) (Fig. 1).

And prohibited these activities to maneuver transfer pricing by the internation companies that carry crossboarder business going to primarily to decrease the tax burden are barred by the distinctive tax behavior of transfer pricing at the global level which is defined by the procedure given by the Organisation of Economic Coperation Development (OECD). The Organisation of Economic Coperation Development guiding principle forced by the arm's length principle as an global standard for the detection and be in charge of transfer pricing in conglomerate businesses which requires that the arm's length principle of transfer prices charged on dealings among associated multinational companies must resolve the market price which would be stimulating for the similar business among dissimilar companies. There should be a single conduct of transfer prices at global point, it is very significant and a solution should be provide to prevent exploitation of transfer pricing transactions by the multinational companies and to offer a fair and objective tax and eliminating the option of double taxation (Brem and Tucha, 2006).

The need for transfer pricing control: Toward shun exploitation of transfer pricing, domestic tax authorities should be inforced to direct the method of transfer prices charged in the business operation among related organisation within the global level. In order to control the transfer price of the state/domestic tax managements to accomplish the budgetary aims above all proposed to stop tax avoidance and to offer a fair and objective company taxes which is internationally acceptable and appropriate for the the multinational companies to comply in a fair and objective taxation of multinational

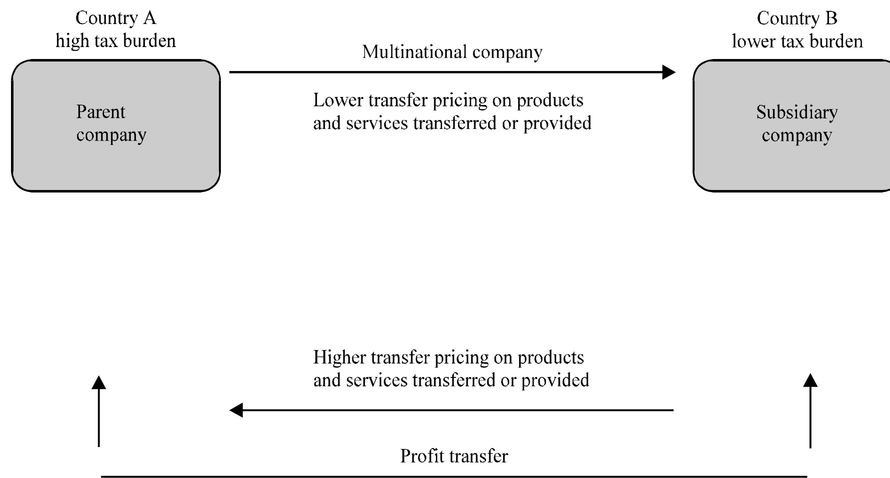

Fig. 1: Purpose of transfer pricing

organization (companies that operate globally) as a exclusive action of transfer prices worldwide. However, the Organsation of Economic Coperation Development (OECD) has gave procedure for transnational transfer pricing and tax regulations. The aims of these strategy is to join the treatment of transfer prices globally by each members of the multinational companies achievement of the Organsation of Economic Coperation Development (OECD) nations in these course of action in nationwide tax systems which will also encourages other nations that are not member of Organsation of Economic Coperation Development plan for transfer pricing purpose in public tax systems.

It is barely by a distinctive action of worldwide transfer pricing and transfer pricing treatment that can be not permitted. The OECD transfer pricing rule forced the arm's length standard as the global standard for the management of transfer pricing and this law is based on the information to facilitate the transfer price in the transaction among allied business venture globally must be with the same selling price charged in the same or similar activities involving among autonomous enterprises. The OECD guiding principle has also explain methods of transfer pricing which should be used to resolve if the transfer price is strong-minded by the arm's length ideology. Finally, Bulend and Robert looked at the most important of worldwide conventional transfer pricing is to attain the aim similarity inside the group which means that the purpose of either the parent or subsidiaries are matching to those of the group. However, is not easy to transfer pricing for the separation of the primary objectives of the company and policies, so the congruence of objectives is the main objective and the performance and estimation of independence.

MATERIALS AND METHODS

Methods of transfer pricing: There are several methods of transfer prices that can be used to determine the price of an arm's length and describes how to apply these methods in practice. Generally follow the OECD transfer pricing guidelines with a focus on practical solutions for the use and application of transfer pricing methods. In response to the practical difficulties that may be present in the application of OECD transfer pricing guidelines. According to OECD these methods are divided in three groups:

- Traditional transactional methods
- Transactional profit methods
- Other methods

Traditional transaction methods: These are the most commonly use methods, these methods primary concerned about analyzing the price that are specified in each and every transaction, controlled by it. Through traditional methods of transactions and the greatest suitable methods of applying the arm's length principle. OECD recognize the transfer prices guidelines are three types of traditional transaction methods:

- Comparable uncontrolled price method
- Resale price method
- Cost-plus method

Transfer pricing under comparable uncontrolled price method is determined by comparing the market price that is charge in related company with the other nonrelated company in the same transaction. In a situation where by

the comparable uncontrolled price mothered cannot be apply, the resale price method is applicable. This method is applied In order to control distributors and also marketing unit's users the resale price method when small value is added and there is no major manufacturing operations. At this situation, the transfer price depend on appropriate marks by means of gross profits discrete, selling the same goods or services by the organization. Nevertheless when all the two previous method cannot be applied the cost-plus method is needed. In this situation transfer price is determined by comparing the sales cost in addition to the gross profit proportion made by the unrelated companies or independent to the related company.

Transactional profit methods: These methods is applicable if the traditional transaction methods are not credible. In this process the transfer price is not the main concern, however the primary concern is the profit gained as a result of transactions between the two related companies. At the beginning of analysis for the profit generated for the transactions made between two related companies that can conclude whether a particular transaction is carried out in line with circumstances that differentiate the arm's length principles. Transactional profit methods mostly is used occasionally in practice, observing in OECD transfer pricing guidelines that transaction profit methods in Hrvoje include the following:

- Profit-split method
- Transactional net margin method
- Other methods

Profit-split method: The special conditions implications are disregarded by profit-split method of profit gotten for transaction between related companies. In addition to that the elimination behaviors is for determining the profit-split which independent organizations would accomplish after similar transactions. For applying the technique of profit-split, the first thing to do is determining the profit-split among related firm's participated in that particular transactions. Afterwards, then to determine the profit-split which would be made if independent firms were involved in similar transactions. This must be determine under current market circumstances. Then assigning the determined stakes in profits to interrelated companies.

Transactional net margin method: Net margin realized is examined by the method of Transactional net margin in transactions with companies relevant to a specific basis like total costs, revenues of sales, assets or equity. Net margin of similar companies in similar business circumstances compares with net margin from transactions between related companies.

Other methods: Other methods offer other ways of transfer pricing which are not included in the transfer pricing methods already mentioned. Other methods are substantially different agreements between companies relevant or between companies relevant and national tax management. OECD's transfer pricing guidelines provide two kinds of such agreements:

- Common costs split agreement
- Advanced pricing agreements

Common costs split agreement: the way related companies split costs is determined by agreements between companies relevant, risks and benefits from specific common functions (for example, research and development, production, supply, accounting and finance, etc). Although, these agreements don't include transfer pricing immediately but they can have a big impact on profit's related companies. For that purpose, they are often under particular consideration of national tax management.

Advanced pricing agreements: Advanced pricing agreements are agreements between national tax administrations and related companies. Through these agreements, the national tax administration and related to the company and approved the transfer price before the deal. Therefore, the process of transfer pricing control is much easier because the transfer price of a controlled transaction is established by agreement between national tax authorities and the company. The purpose of advanced pricing agreements that there are disputes have to be resolved in a timely manner and to shun costly claim. Two-third of multinational companies in a recent study said that it is expected to use agreements of advanced pricing in the determination of their transfer prices. However, Veres (2011) observes that there are only two key theoretical pricing methods as follow:

- The cost-based
- The market-based pricing

The cost-basedmethod is the easiest method apparently relying on costs and the anticipated profit. On the other hand, the two categories require a broad base of information and a variance analysis. The cost content is fundamentally based on the historic value of

the product. The direct resource requirement of the historic value can generally be measured well, the expenses must be covered by natural price which cannot allocate directly to the product or activity for objective of long-term transaction. In market-based pricing is cost structure which helps the expected profit to be achieved, also established on the basis formation of the price and according to the information. Thus, this concept refers to the target cost calculation issue where establishes the historic value of the product on the basis of market information and taking into account the customer's needs in terms of quality, sustainability, substitution and related services (Adams and Drtina, 2010).

Problems of transfer pricing: There are several problems of transfer pricing which as result in current systems of corporate taxes that allow companies with cross-border activity to avoid the tax, because there are big differences between the companies and rules under which each subsidiary subject to tax rates on income taxes based on the activity in the host country. Economic integration has led to the complexity of tax issues for businesses and reduces the ability of financial management to monitor trade flows and cash flows for companies with cross-border activity. The economic globalization also reduces the ability of financial administrations to verify the precision of transfer prices used by taxpayers, thanks to a significant increase of the foreign company and diversify their income. To avoid the possibility of manipulating of the tax systems of companies through transfer pricing, financial authorities impose requirements for the preparation of certain documents relating to the determination of transfer prices, increasingly more stringent. Thus, companies are faced with a situation where they need to improve complex documents on transfer prices of all countries where it operates, so they are more likely to bear the penalties for non-compliance with the requirements of the financial authorities. Apply different methods to determine the correct transfer price is becoming more complex and costly, since the new technologies and business structures (referring to an increased emphasis on intangible assets of the company) was created difficulties identify uncontrolled commercial transactions necessary to properly transfer prices for comparison. There are also significant differences in the rules for application of methods of transfer pricing between companies face uncertainty on the prices of intra-group transactions, because they can be considered unacceptable by the financial authorities in an audit later. Adjustment of transfer pricing, made after auditing the financial authorities, can lead to risk of double taxation (Matei and Pirvu, 2011).

Transfer pricing rules and its tomorrow perspective: The issue of transfer pricing has become increasingly significant in a globalized economy as more companies expand their transactions beyond the borders of the country of origin, make transactions which include goods and services within the group. In principle, transfer pricing rules recommended by the OECD provides the following conditions are that the transaction should meet to fall under the transfer pricing systems:

- The existence of cross-border transactions
- The transaction takes place between two affiliated entities
- The transaction will be subject of a good, service or any other thing with economic value (Matei and Pirvu, 2011)

As a transfer pricing may also have other objective of tax avoidance, financial authorities must not automatically assume that company's activity across the border trying to manipulate profits, in particular, in some cases is very difficult to accurately determine the market price. The Finance Committee created by all OECD rules to reduce the risk of misunderstanding or abuse with respect to taxes on some of the transactions in groups of companies, implementing the so-called "arm's length principle". Tax convention OECD explained the essence of this principle model: "(when) conditions are made or imposed between the two (associated) enterprises in trade or financial relations which differ from those between independent companies, then any profits which would but for those conditions have accrued to one of the companies but because of those conditions are not due to accrued in the profits of that company and taxed accordingly" (Matei and Pirvu, 2011).

According to Brem and Tucha 2006 (the changes that led the entire world of tax and the business world needs to re-examine transfer pricing, according to the appropriate theory of the multinational firm. Therefore, the approach of the next generation of transfer pricing to the government to characterize the patterns and appreciate the functional contributions of the value chain. It is likely to be for the design and/or establishment of the arm's length behavior within the MNE. Given the governance structure of (related-party) transactions and analysis of value chain with risk-averse markups on routine functions and remaining profit divided remuneration for non-routine functions are likely to replace the bilateral approach to transfer pricing today.

RESULTS AND DISCUSSION

Overview of transfer pricing in some selected countries: In this study, we highlight some transfer pricing issues in some selected countries as follows: Australia, India, Malaysia and Kazakhstan.

Transfer pricing in australian service organizations: According to research conducted by Terzioglu (2016) that Most studies have focused on transfer pricing (domestic or international) manufacturing organizations. This research reports the results of a survey of the domestic transfer pricing practices, especially, objectives and working methods of Australian service organizations. However, explore the concept of "value to internal customers" in the transfer pricing transactions of service organizations. The responses to survey 80 great Australian service organizations indicate thatthe most important goals are congruence and understanding transfer pricing easily. Terzioglu (2016) also indicates that the transfer pricing method based on value which is not applied and the lack of awareness of and interest value to inland customer classified the inland markets inside the Australian service sectors.

Transfer pricing (impact of taxes and tariffs in india): In this research, Gupta (2012) discovers the impact of corporate taxes and customs duties on the product which described" transfer pricing of Multinational Corporations (MNCs)" in India using the Swenson Model. This study was allocated from the origin of imports from Japan, Germany, France, Italy, China, Switzerland, Singapore, United States of America and United Kingdom to India reveals that incentives of transfer pricing resulting from taxes and customs duties to provide an opportunity for multinational corporations to manipulate transfer price to maximize profits through sites worldwide transactions and reducing liability of tax (Gupta, 2012).

Transfer pricing tax audits in asia pacific (the case of mnes in malaysia): According to "Lai *et al*. (2013)" that with the increasing number of multinational corporations investing in the Asia-Pacific area, transfer pricinghas become more difficult for businessand tax authorities in this area of the issue of tax. Moreover, that factors that can lead to a revision of multinational companies operating in transfer pricing Malaysia is examined in this study. Data collected from the tax authorityshows that Multinational companies with a low net profit margin were vulnerable to scrutiny. Emphasis was disproportionate to audit on larger Multinational companies (MNEs). Include multinational companies audited manufacturers, distributors/retailers or those service industries and involved primarily in material goods and services within the group. The results indicate that the "Malaysian tax authority" has become more vigilant in auditing of transfer pricing and with the new guidelines of the" Organization for Economic Co-operation and Development" (OECD) and United Nations to fight international transfer pricing tactics, audit strategy and operations are bound to grow in size, scope and sophistication.

Problems of transfer pricing tax regulation in the republic of kazakhstan: In the study which conducted by Eishebayeva and Alpysbayeva it is essence to the role of transfer pricing in current economic conditions in Kazakhstan. It should be noted that the differences in the use of the transfer prices, provided that ambiguous approaches to this problem. As it happens, Kazakhstan special attention is given to transferpricing problems in relation to the characteristics of the main factors of the economy developing in Kazakhstan. It presents the results of the tax revenues; the dynamics of exports and imports; capital outflows and investment in flows. It is a progressive development problem and improves national legislation on transferpricing.

Specific investment and negotiated transfer pricing in an international transfer pricing model: This study is conducted by Durr and Gox (2013) which explains effectiveness of negotiating transfer pricing in order to solve the problem of a bilateral hold-up in a multinational company. It alsoproved to be negotiated transfer pricing generallydo not provide incentives to renegotiate the most effective initial investments effective contracts because of divisions one instrument to solve both problems. Either they reduce taxes or redistribute the profits of the efficient trade. The second best solution to solve the problem of the renegotiation under constraint of the arm's length. As a resultthe company is the implementation of the preliminary contract or completely ignore the tax considerations when aquantity amendment. He also believes that the investment decision optimal and the contract ex-ante optimal are ruled by the nature of the different international taxation (Durr and Gox, 2013).

CONCLUSION

The purpose of this study was to explain and clarify transfer pricing objectives and methods, also the present study has examined modern consideration of transfer pricing that means the price paid in transactions between

related companies. In addition, this study has employed information on problems and difficulties of transfer pricing, application which is becoming increasingly complex and costly. Thus, to evade the possibility of manipulation of the tax structures of companies through transfer pricing, financial authorities execute requirements for the preparation of certain documents relating to the determination of transfer prices and more stringent. Also, this study showed some rules of "transfer pricing" which recommended by "OECD" where provide the next conditions that a transaction must meet to fall below the "transfer pricing" principles, the existence of cross-border transactions, the transaction takes place between two associated entities and the transaction will be subject of a good, service or any other thing with economic value. We conclude this study by overview in transfer pricing issues in some selected countries (Australia, India, Malaysia and Kazakhstan).

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