

# Pricing for Global Markets

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*Pricing is complex and generally subjective in domestic business. It is even more difficult in international business, with multiple currencies, trade barriers, additional cost considerations, and longer distribution channels. Based on a review of corporate best practices, this article proposes a set of decision rules and processes for international price setting. Specific topics for discussion include: key considerations in international pricing; the location of pricing responsibility in the multinational corporation; approaches to price setting; and transfer pricing practices.*

### **The globalization of marketing**

has put tremendous pressure on MNC pricing systems. Over the past few decades, as companies moved from purely domestic operations to exporting and then to overseas manufacturing and marketing, they had to transform their pricing structures. Those structures, originally set up to function in a single-market setting, had to be adapted to the much greater heterogeneity of the international environment.

Today, perhaps for the first time, the operating environment that MNCs face is replete with complexities, including competition, an increasing number of global players, rapid technological change, and high-speed communication among markets.

Executives of internationally oriented firms must now grapple with many questions to which there are no simple or precise answers; for example;

- What is the best approach for setting prices worldwide?
- Which variables should be considered in arriving at prices for foreign customers?
- What level of importance should be attached to each variable?
- Where in the global company should pricing decisions be made?
- Should prices vary across markets? By customer types? Over time?
- Should price play an active or passive role in a company's international competitive strategy? and
- What factors should MNCs consider in setting transfer prices?

Most executives are quick to recognize that pricing decisions cannot be made in isolation, since pricing interacts with and affects all other marketing policy variables. Among other things, prices do the following:

- Influence customers' perception of value;
- Determine the level of motivation that can be expected of intermediaries;
- Have an impact on promotional spending and strategy; and
- Compensate for weaknesses in other elements of the marketing mix.

The purpose of this article is to review corporate practices in international price setting. Price determination is far from being scientific in the international environment. Pricing becomes, in part, trial and error and partly hard calculations by management. Yet, managers have developed a set of decision rules and successful approaches to setting prices for international customers and subsidiaries. The discussion here crystallizes this thinking and suggests a more systematic approach.

### **Factors That Affect Global Pricing**

Global managers readily acknowledge the critical role of prices in overseas marketing success. After all, prices do have a measurable impact on sales and directly affect profitability. They often invite competitive reaction and, indeed, can be driven down by determined competitors. Conversely, they can escalate to unreasonable levels because of tariffs, taxes, necessary increases in markups to cover rising costs and so on. They can complicate a firm's marketing

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strategy in unforeseen ways when price variations among different markets lead to gray-market imports (Cavusgil and Sikora 1988). Finally, prices are one of the most flexible elements of the marketing mix, because they can usually be changed relatively quickly.

Consequently, MNCs take great time and care in establishing pricing policies and setting prices for international customers. In addition to the basic factors of production cost, demand and competition that must be considered, pricing decisions for the global market must take into account variables such as exchange rate fluctuations and duties as well as external costs, e.g. documentation, freight and insurance.

Within the large constellation of factors that influence pricing for international markets, the five discussed below stand out as most important.

## **1 Nature of Product or Industry**

A specialized product, or one with a technological edge, gives a company price flexibility. In many markets there is no local production of the item, government-imposed import barriers are minimal, and importing firms all face similar price escalation factors. Under such circumstances, producers are able to remain competitive with little adjustment in price strategy.

A relatively low level of price competition usually leads to administered prices and a static role for pricing in the marketing mix. In such instances a "skimming" price strategy is often used. Eventually, however, as price competition develops and technological advantages shrink, specialized and highly technical firms must make

more and more market-based exceptions to their previously uniform pricing strategies.

Pricing strategies are also influenced by industry-specific factors, such as fluctuations in the price and availability of raw materials. In order to reduce uncertainty, a growing practice of companies is to negotiate fixed-price agreements with suppliers before making their own bids for major contracts.

Another problem for corporations in some industries is predatory pricing by particularly aggressive competitors. Recently, that strategy has been pursued mainly by market-share-hungry new players, most notably those from just recently industrialized countries (NICs) in Asia.

## **2 Location of Production Facility**

Despite the proliferation of foreign-owned manufacturing facilities around the world, many companies' only participation in the global market is by exporting products they make in their home countries. The usual reason is that the volume of their sales abroad is simply not large enough to justify foreign sourcing and manufacturing.

When production is kept at home, a company is tied to conditions prevailing in that market, a circumstance that reduces its pricing flexibility in its export markets. Economic and political developments at home—and even natural disasters—can force export prices up at a time when local producers in the overseas market or exporters from third countries are not similarly affected and can keep prices low.

One example might be a trade embargo observed by only a few govern-

ments. Because of the boycott, the supply of certain needed raw materials would be reduced, driving up the cost of making some products. Competitive products made in nonboycotting countries would obviously enjoy a clear price advantage in export markets.

In contrast, companies that manufacture abroad often enjoy greater pricing flexibility both in the countries in which they are located and in export markets. In addition to being better able to calibrate production to local demand and competitive conditions, those MNCs find it easier to respond to foreign exchange fluctuations. Mazda paid a hefty price for not building production capacity outside of Japan. As the Japanese yen appreciated significantly in the mid-90s against the U.S. dollar and most other currencies, Mazda's exports of vehicles from Japan became prohibitively expensive. Mazda's only assembly plant outside of Japan, the Flat Rock, Michigan, facility never became a big factor. After registering big losses for several years, Mazda's chief creditor, Sumitomo Bank, finally asked Ford to take a controlling interest in Mazda and appointed a Ford executive as its new president (Reitman, 1996).

### **3 Distribution System**

The channels of distribution a company uses dictate much in international pricing, particularly export pricing. When a company is able to distribute its products through its own overseas subsidiaries, it has greater control over final prices, including the ability to adjust prices rapidly, as well as firsthand knowledge of market conditions.

An exporter working with independent distributors, however, usually finds that it can control only the landed price (the exporter's price to the distributor). As one might expect, many exporters are concerned about the difficulty of maintaining price levels. Some firms report that distributors mark up prices substantially—up to 200 percent in some countries. Use of manufacturers' representatives gives a company greater price control, but this method is used less frequently by U.S. companies, which usually require a "full-service" intermediary in the export market.

Direct selling to end users is necessary in many industries, especially those involving large systems or technical equipment. In the case of sales to government agencies, a protracted bidding process and negotiations preclude the use of list or other standard prices. Firms often attempt to establish more direct channels of distribution for reaching their customers in overseas markets. Indeed, that is sometimes a motivation for establishing a company-owned subsidiary. By reducing the number of intermediaries between the manufacturer and the customer, the adverse effects of successive markups can be avoided.

### **4 Location and Environment of the Foreign Market**

Pricing is affected by factors not always immediately perceived as price related. For instance, climatic conditions in foreign markets may necessitate costly product or distribution modifications, and prices must be adjusted to cover those extra or special expenses. A maker of soft drink equipment must treat its machines intended for tropical markets to prevent rust corrosion, while an agribusiness must take into account climate, soil conditions, and the coun-

try's infrastructure before making any bid.

### **5 Foreign Currency Differentials**

Economic factors, such as inflation, exchange rate fluctuations and price controls, may hinder market entry and effectiveness. These factors, especially the value of the U.S. dollar in foreign markets, are a major concern to most firms. The dollar's unusual strength in the first half of the 1980s, in fact, led a number of companies to introduce compensating adjustments as part of their pricing strategies. In contrast, during the first half of the

#### **Exhibit 1**

##### **International Pricing Strategies Under Varying Currency Conditions**

###### *When the Domestic Currency is Weak*

Stress price benefits.

Expand product line and add more costly features.

Shift sourcing manufacturing to domestic market.

Exploit export opportunities in all markets.

Use a full-costing approach, but employ marginal-cost pricing to penetrate new or competitive markets.

Speed repatriation of foreign-earned income and collections.

Minimize expenditures in local or host-country currency.

Buy needed services (advertising, insurance, transportation, etc.) in domestic market.

Bill foreign customers in their own currency.

###### *When the Domestic Currency is Strong*

Engage in nonprice competition by improving quality, delivery and after-sale service.

Improve productivity and engage in vigorous cost reduction.

Shift sourcing and manufacturing overseas.

Give priority to exports to countries with relatively strong currencies.

Trim profit margins and use marginal-cost pricing.

Keep the foreign-earned income in host country; slow down collections.

Maximize expenditures in local or host-country currency.

Buy needed services abroad and pay for them in local currencies.

Bill foreign customers in the domestic currency.

1990s, U.S. exporters enjoyed a much weaker currency, boosting their sales in international markets.

Since currency fluctuations are cyclical, exporting companies that find themselves blessed with a price advantage when their currency is undervalued must carry an extra burden when their currency is overvalued. Companies committed to serving international markets must be creative, pursuing different pricing strategies during different periods. Appropriate strategies practiced by a broad cross-section of MNCs are presented in Exhibit 1.

### The Locus of Pricing Decisions in MNCs

#### *Centralized Pricing*

International pricing decisions are centralized in most global companies. There are several reasons for that:

**1** Increasing globalization of markets requires greater uniformity of prices across markets. The existence of differing prices from country to country often leads to gray-market imports, i.e. the sourcing of a product from low-price countries by unauthorized intermediaries for sale in high-price countries. This results in the creation of a distribution channel parallel to authorized channels but not under the control of the manufacturer in any way.

**2** Global companies encounter the same competitors in many markets, requiring globally coordinated competitive strategies. A fragmented strategy often leads to suboptimal results.

**3** At some companies, pricing is closely related to production-volume planning. Since volume planning is usually done at the corporate level, it requires centrally directed prices.

**4** Typically, the parent company wants to forecast its annual revenues worldwide. Therefore, it must be able to estimate the sales of all its operations, including its overseas subsidiaries. This often dictates setting prices centrally or, at least, imposing some guidelines for the prices to be set by subsidiaries.

**5** Many corporations seek tight control over pricing of their "global" brands, that is, those aimed at a homogeneous market segment in many countries and positioned similarly from one market to another. To create a uniform image across national boundaries, not only the product, but the price, must be consistent. The price is normally set by corporate headquarters relative to the prices of competing local products in each market. The policy might state, for example, that the brand must always be premium priced relative to local products and that "premium" is defined as, say, 20% above the price of the most expensive locally produced item. Such a policy limits local autonomy in setting prices. An example of a global brand priced in this manner is Grand Metropolitan's Smirnoff vodka. Gillette is another company that seeks a global brand image for its products.

Also important to a company's pricing policies and practices is the proximity of its overseas markets to one another. When markets are close geographically, a country subsidiary cannot set prices for its own market

in isolation. No subsidiary can mark up the price to the point at which customers will seek to import the product rather than buy locally.

Centralized pricing management by the parent company or a regional office is often the only way to prevent subsidiaries from undermining one another's pricing programs.

#### *Decentralized Pricing*

Although global companies generally maintain centralized control over local prices, they do allow subsidiaries to alter prices when warranted by local conditions. In some situations, subsidiaries may, in fact, receive complete pricing autonomy because of competitive considerations.

Headquarters executives cite the following reasons for giving subsidiaries or distributors leeway to set local prices:

- **Timing.** There may be a need for a quick response to price changes made by competitors.
- **Relative market share.** If the brand is one of many in a local market, the subsidiary will be forced to follow the prices set by the market leaders. Conversely, market leadership allows greater pricing freedom.
- **End-user characteristics.** If the local market is relatively poor, with most consumers at lower income levels, the local subsidiary may have to deviate from centrally determined pricing guidelines.
- **Specific local cost factors.** Value-added taxes and the cost of adapting a product to a particular market may demand greater price flexibility in some countries.

• **Transportation costs.** These vary widely from country to country owing to the nature of the distribution infrastructure, the extent of unionization in the transport industries and the stipulations in local distribution laws.

• **Economic and financial conditions.** Interest rates and inflation often cause local divisions to sway from corporate pricing guidelines. Local prices must reflect currency realities if earnings are to be eventually transferred to the home country.

• **Capacity utilization.** A subsidiary with excess capacity in a local market may choose to lower prices to boost demand, while tight capacity may suggest an advantage in charging higher prices.

A medium-sized MNC that has adopted a decentralized price policy is the Taiwan-based personal computer firm, Acer. The home office, in Lungtan, consults closely with its regional and country offices to determine market conditions and formulate general market strategy and objectives, such as targets for net revenue, market share and the growth rate for gross sales. Local distributors are also encouraged and given autonomy to devise their own value-added solutions, which allow them in some cases to sell the same product for different prices, depending on the nature of the total package. Acer's marketing and sales headquarters in Taiwan provides technical, logistical, promotional and finance services. However, on the basis of the above objectives as well as cost information provided by Lungtan, local subsidiaries receive virtually total autonomy in setting their retail prices.

### *A Delicate Balancing Act*

How do global corporations resolve the conflicting needs for centralization and decentralization of pricing decisions? Typically, the corporate office sets policy and issues general guidelines to which the overseas subsidiaries and distributors must adhere. The guidelines are usually written at the beginning of each fiscal year—or more often, if necessary. Pricing policies reflect both the general direction prices should take during the course of the year and the company's underlying global strategy. For instance, an American manufacturing company's 1996 policy is that prices are not to rise more than one percent over 1995 prices. The company adopted this policy in an attempt to fend off its chief rival.

Once a broad pricing strategy is set by a company's home office, subsidiaries and distributors are allowed to make adjustments locally because of the considerations listed above. In some companies, the degree of pricing flexibility given to the subsidiary is defined precisely. For example, headquarters may allow local prices to deviate 5–15% from the centrally established prices.

In practice, pricing freedom is transferred to local subsidiaries from headquarters through three main mechanisms:

- A system of discounts on sales to intermediate customers;
- Credit arrangements and terms of sale; and
- Transfer prices charged to subsidiaries.

Exhibit 2 outlines the process of price determination in Kodak's inter-

national distribution channels. The process includes the setting of key prices at various levels in the channel and the factors which must be taken into account at each level. Most global companies start out by setting a single worldwide price, sometimes referred to as the manufacturer's list price or manufacturer's transfer price. However, the effective price or the price charged to intermediate customers (e.g., overseas distributors, or subsidiary) is determined by a discount system. The discount rate varies for different customers and territories on the basis of competitive considerations, exchange rates, landing costs etc. The discount structure, which is reviewed frequently, thus becomes a vehicle for transferring greater pricing autonomy to subsidiaries and intermediate customers.

The company as a whole benefits as a result of a pricing system that is responsive to local needs. Similarly, credit terms and other variable conditions of sale have a direct impact on the final cost to subsidiaries and intermediate customers.

Finally, transfer prices charged to subsidiaries can also be adjusted to increase the subsidiaries pricing flexibility. Transfer pricing practices are discussed later in this article.

### **Approaches to Price Setting**

Clearly, there is no single approach to international pricing that is best for every company and every situation. Exhibit 3 presents one approach to setting prices for international customers. A sequence of key tasks are identified. What is important for the manufacturer to remember is that suitability of the prices must be examined at several levels in the international distribu-

## Exhibit 2

### Setting of Prices at Various Levels in the International Distribution Channel: Kodak Example

| Key Steps in Price Setting               | Relevant Considerations  |
|--|--|
| Manufacturer's Transfer Price            | Source of supply; costs; availability; tax rates; repatriation of earnings difficulties  |
| X  |  |
| Discount Factor (O1)                     | Relative importance of market; size of customer; nature of customer (distributor vs. subsidiary); negotiations; product-line considerations; competitive considerations; marketing strategy (e.g., consumer pull vs. distributor push; skimming vs. market-oriented pricing); gray market considerations; exchange rates |
| =  |  |
| Factory Billing Price                    |  |
| +  |  |
| Distributor Gross Margin                 | Competitive considerations; volume and share objectives; pricing strategy (e.g., profit taking vs. penetration); aggressiveness; support and incentives provided to retailers  |
| +  |  |
| Local Costs                              | Freight, insurance, customs, duty, taxes, etc.   |
| X  |  |
| Exchange Rate Adjustment                 | Inflation rate; balance of payments; debt; government policy   |
| =  |  |
| Distributor's Exit Price<br>(List Price) |  |
| +  |  |
| Value Added Tax                          | Type of product; government policy   |
| +  |  |
| Retailer's Mark-up                       | Going rate; competitive intensity; incentives and support provided by distributor; aggressiveness; product-line considerations (e.g., loss leader pricing)   |
| +  |  |
| Value Added Tax                          | Type of product; government policy   |
| =  |  |
| Retail Price                             |  |

tion channel—the importer, wholesalers, retailers, and so on. At most companies a product's price starts with a "floor price," which is the lowest possible price at which the product may be retailed or wholesaled (depending on the nature of the company). The floor price is derived from the total cost of bringing the

product to market plus a corporate markup. Costs typically include R&D, raw materials, processing, transportation, distribution, marketing and administrative overhead.

Arriving at the correct floor price is not as easy as it seems. As the following examples suggest, the process is complicated because of differences

in cost accounting practices, company policies (such as whether or not to factor in domestic overhead), global manufacturing and sourcing factors, and so on.

- Seiko Epson, the Japanese computer peripherals manufacturer, sets floor prices at headquarters after considering costs, recommendations

### Exhibit 3

#### A Decision Making Framework for International Pricing

Estimate the price of the product "landed" in the foreign market by considering international customer costs (documentation, freight, insurance, etc.)

Estimate the price the importer/distributor will charge by considering tariffs and intermediary profits

Estimate target price range for end users  
Estimate floor, ceiling, and expected prices

Assess company sales potential at given prices

Examine corporate goals and preference for pricing strategy

Select suitable pricing strategy:

- Rigid cost-plus
- Flexible cost-plus
- Dynamic incremental

Check consistency with current price setting across product lines, customers, and markets

Implementation:

Select tactics, distribution prices, and end users prices

Monitor market performance and make adjustments as necessary

cent above or below the base price. Salespeople in headquarters are allowed to negotiate prices within these parameters with country-level sales affiliates. In view of the rapid technological change and rapid entry of new products in that industry, this sort of price flexibility is considered essential by marketing staff.

- Hewlett-Packard leaves the responsibility for setting floor prices ("factory base prices"), which are derived from production costs, to the product divisions. In the past, factory base prices coincided with U.S. prices, but that is no longer the case, because of the development of overseas production facilities and sourcing. In calculating floor prices, a currency differential (premium) is added when necessary. Management then assesses the competition in major markets and builds an appropriate profit premium into the price.

- One U.S. manufacturing company sets the same list price (fob factory) in the U.S. and abroad. In arriving at the discount structure for its dealers, this industrial manufacturing MNC takes into account the exchange rate, local competition and a reasonable profit margin for the dealers. Final prices, which tend to be at the high end of the range in each product category, also reflect such elements of the company's strengths as service, technical support and a comprehensive warranty.

from executives in the company's various manufacturing divisions and country markets and a corporate profit markup target for the particular product. Starting from this figure, product division presidents at headquarters establish flexibility parame-

ters. Low-end products—such as Epson's LQ-500 series printer—are usually restricted to a variability range of less than 5 percent, while the prices charged for high-end products like computers and laser-jet printers can range from 10 percent to 25 per-

## **Options in Export Pricing**

Companies have three basic options in setting prices on exports (Cavusgil 1988):

**1 Rigid cost-plus pricing.** The complexity of export pricing has caused many managers to cling to rigid cost-plus pricing, a formula that ensures margins but may push the final price so high that the company becomes uncompetitive in major markets. The foreign list price is set by adding international customer costs and a gross margin to domestic manufacturing costs. The final price to the foreign customer includes administrative and R&D overhead costs, transportation, insurance, packaging, marketing, documentation and customs charges as well as profit margins for both the distributor and the manufacturer. Cost-plus pricing is a static element of the marketing mix, since it cannot be changed to any significant extent.

**2 Flexible cost-plus pricing.** This strategy sets list prices in the same way as the more rigid system but allows for price variations in special circumstances. For example, discounts may be applied to the final price, depending on the customer, the size of the order or the strength of local competition. Although there is more room to adapt export prices to local conditions, the primary objective of this approach is still to maintain profit margins. It, too, is thus an essentially static element of the marketing mix.

**3 Dynamic incremental pricing.** This method assumes that fixed costs are incurred regardless of the company's export sales performance. Therefore, it seeks to recover only

variable and international customer costs in export prices while adding in a partial overhead factor rather than the full overhead load. This approach enables the company to sell its exports at very competitive prices, perhaps enlarging its market share.

Most companies that use dynamic incremental pricing do so only under special circumstances. For example, one U.S. industrial MNC negotiates "one-shot" deals with its distributors, offering them low prices when it has a sufficient quantity of the product, when the sales potential is good or when competitive pressure necessitates aggressive pricing.

In some cases, dynamic incremental pricing helps a company introduce a product to a market. Under this strategy, also known as "penetration" pricing, the introductory, or "market floor," price is the lowest possible. The objective is to gain as much market share as possible in the shortest time. Once the product attains a sufficient market share, prices tend to increase slowly.

Over the past few decades, Japanese and Korean MNCs in particular have successfully used penetration strategies in the U.S. and other Western markets, often inviting dumping charges by local marketers. When carried to extremes, however, as when a company charges a price lower than the cost of making the product or the product's domestic price, penetration pricing may run afoul of local antidumping laws, that are in effect in many countries.

Whereas in penetration strategies introductory prices start low and slowly rise, in "skimming" a company introduces the product into a market at a relatively high price, often while limiting distribution.

This can be an effective method for launching innovative, high-tech items, such as advanced consumer electronics devices or trendy products. A certain segment of the market will pay premium prices to be first to have such things, which are usually introduced amid great excitement, highly visible advertising and extensive media coverage. As with a penetration strategy, the price slowly comes into line with the product's price in other countries. Dynamic incremental pricing also implies skimming when it coincides with a dominant market share position, as other companies cannot afford to ignore the price leader's practices. Several years ago, Cummins Engine reduced its engine prices dramatically in Europe, the Middle East and the Far East to about 70 percent of its previous price. This strategy was successful in limiting the inroads made by the company's Japanese competition.

## **Transfer Pricing Practices**

One of the thorniest problems global companies grapple with when they venture beyond their home-country borders is transfer pricing (also known as "intracompany pricing"). The prices at which units of the same company sell to each other have a far-reaching effect on the company's success because they influence everything from foreign subsidiary performance to executive compensation to tax obligations. There has never been a single "best" way to set transfer prices, one that satisfies both the parent company and its foreign affiliates (not to mention the tax collectors in all countries concerned). Nor does any system meet all the needs of production, marketing and finance equally well.

Global companies attempt to manage their corporate families' internal prices primarily for two reasons. First, transfer pricing can become a vehicle for repatriating profits from those countries that have remittance controls. In the extreme case, funds may be blocked by the central bank, and transfer pricing may be the only means of getting earnings out of the country. Second, transfer pricing can be a way to shift profits out of high-tax countries and into low-tax ones. Underlying both objectives is the desire to foster corporationwide efficiency. While individual units may show poor performance, the company as a whole can achieve optimal results by means of careful transfer pricing. For this reason, MNCs typically centralize transfer pricing under the direction of the chief financial officer.

Companies have available a number of transfer pricing strategies available. Products can be sold to

members of the same corporate family at cost or a variation of direct cost, at market prices, at inflated prices or at some combination of these. Some global corporations use different transfer pricing methods for different purposes, accepting the cost and complexity of maintaining more than one system. Others opt for the simplicity of a single approach, accepting the inevitable deficiencies of whatever system they choose. The following are among the possible alternatives.

- **Actual cost**, which is sometimes viewed as the absence of a transfer price, can be used for intracompany transactions. Manufacturing facilities are treated as cost centers rather than profit centers, an approach that resolves many internal disputes over allocation of profits. A disadvantage of the method is that it leaves the cost centers with little inducement to make investments, leading to additional inefficiencies for the company as a whole. Another problem is that tax authorities generally do not accept this technique, unless some taxable profits are allocated to the supplying unit.
- **Standard cost**, unlike actual cost, has the advantage of identifying efficiencies or inefficiencies in the supplying unit. It also facilitates "management by exception" decisionmaking, in which variations from standard cost signal the need for additional investigation and attention by management. A major shortcoming is that standard costing often requires management to make arbitrary assumptions and leaves the company vulnerable to expending time unproductively in debates on how to set the standards.
- **Modified cost** is useful in promoting achievement of strategic objectives. For example, actual or standard costs are sometimes adjusted to encourage more extensive use of certain products or services. Companies that expect to have unused capacity for a time often lower their transfer prices in order to provide incremental contributions to the coverage of "sunk" costs. Among the modifications available are variable costs (those costs of materials, labor and overhead that vary directly with the number of units produced), marginal costs (the costs of producing one more unit) and full absorption costs (costs that would not change if sales to other business units stopped—for example the cost of shared factory overhead).
- **Market price**. Prevailing external market prices (arm's-length prices) are often viewed as the best transfer pricing mechanism for external reporting. Because this approach removes internal bias and facilitates validation, it appeals to outside parties, such as tax authorities. From a performance evaluation perspective, however, market prices may be unfair because they give the supplying business unit the entire profit on the transaction, including the benefit of any cost reductions due to global efficiencies. To equitably share the advantage of lower costs, transfer prices must be lower than market price.
- **Modified market price**. Market prices can be adjusted to reflect specific characteristics of the goods or services involved. For example, they may be reduced to reflect lower marketing or distribution costs that occur in external markets. Ordinarily,

this will help resolve perceived inequities among supplying and receiving business units. However, a supplying unit that has no excess capacity will still feel unfairly penalized if the lower price cuts into the profits the unit would otherwise earn on external sales. In such a case, the external profit is a relevant opportunity cost and it should be factored into the transfer price.

- **Negotiated prices** are determined by bargaining between the buying and selling units. Although some executives may argue that this technique results in an arm's length transaction that is just as valid as an external market price, its use in evaluating the performance of subsidiaries has some risks. For instance, negotiators may fail to reach agreement, which could result in counterproductive and expensive procurement of goods and services from outside the firm. Another problem is that excessive internal competition can undermine the achievement of congruent goals among business units and result in a serious loss of cooperation.
- **Contract price.** A variation of the negotiated price method is a price agreed upon at the time the firm's business plan is adopted. Such a "contract" price eliminates variations that result from centralized sourcing decisions beyond the control of managers of foreign operations. One drawback of the method is that it does not pass on price hikes in raw materials to marketing units. As a result, it removes the marketing unit's incentive to recover any inflationary and foreign exchange losses through third party pricing.

How do global companies choose among these transfer pricing possibili-

ties? Many factors are involved in deciding which transfer price to use and whether to use different prices for reporting external and internal performance. Sometimes one issue is of overriding importance to a company, clearly dictating a particular pricing system. More often, however, a company's situation is mixed, making the choice highly complex and probably contentious. For most companies, the decision involves some combination of the considerations discussed below:

- **Local taxes.** Perhaps the most significant concerns in setting transfer prices are the local tax rate and pertinent tax regulations. The use of transfer pricing to shift profits into local jurisdictions that have relatively lower corporate tax rates normally results in lower overall income taxes. However, high prices for capital assets increase the depreciation allowances for the business units that receive them. This lowers overall taxes when the assets are transferred from lower- to higher-rate jurisdictions.

An effective transfer pricing system should deal with changes in import-export duties, income taxes, excise taxes, etc., in a way that minimizes these taxes overall.

Generally, lower transfer prices mean lower levies; prices in excess of certain thresholds may result in higher import duties, especially if they are assessed on an ad valorem basis. Similarly, keeping transfer prices low can reduce local value-added taxes. VATs are based on the value added within the taxing jurisdiction and are factored into the price at the next sales level.

- **Currency fluctuations.** Transfer prices can be adjusted so as to balance the effect of fluctuating currencies when one subsidiary operates in an environment of low-level inflation and another in a climate of rampant inflation.

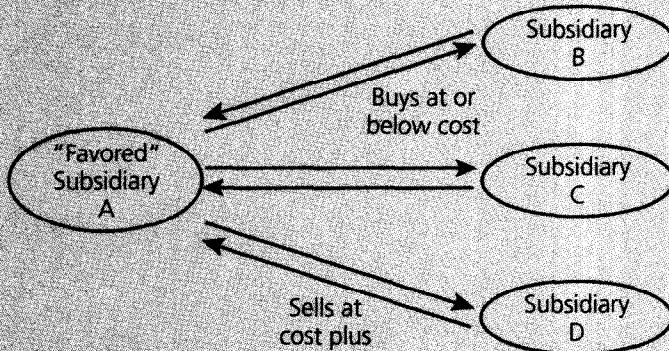
- **Subsidiary profits.** Still another use of transfer pricing is to manipulate the profit position of a subsidiary. For example, startups often require substantial corporate assistance, which can be provided in the form of lower purchase prices from or higher sales prices to other company units. In this way, a market niche can be carved out more quickly for the startup and its long-term survival guaranteed.

- **Expense accounting.** Transfer prices can also be used to advantage when the host government poses restrictions on allowable deductions for expenses. Sometimes certain services, such as product development or strategic planning assistance, are provided to the subsidiary but cannot be charged because of restrictions. In that case, costs for those services can be recouped by increasing the transfer prices of components sold to the units.

- **Joint venture support.** Similarly, transfer pricing can help recoup expenses from a joint venture, especially if there are restrictions on repatriation of profits. Lowering the prices of products and services to a parent reduces the outflow of funds from the home country, while raising the prices of purchases from the parent shifts funds to the home country. When government imposes local price controls, transfer pricing practices may again help. Higher transfer prices on exports of intermediate

#### Exhibit 4

#### How Transfer Pricing Can Help Maximize Corporation-wide Reported Earnings



*Subsidiary A is likely to be in a country that has:*

- Low corporate income tax
- High tariffs
- Favorable accounting rules for calculating income (e.g. allowable deductions)
- Political stability
- Little or no restrictions on profit repatriation
- Strategic importance to company

goods from a parent to a subsidiary in such a market may help support the case for an increase in the price of the final product.

- **Output capacity.** Subsidiaries with substantial excess production capacity can set transfer prices low enough to encourage additional internal consumption but high enough to cover the supplying unit's variable costs.

Exhibit 4 illustrates graphically the dynamics of transfer pricing among the members of the corporate

family. In this illustration, Subsidiary A is considered a "favored" subsidiary since it is allowed to source at a low cost and sell at a high price when transacting with other subsidiaries. The corporate reasons for this are also outlined.

As implied by the above discussion, the ability to control internal prices charged to subsidiaries affords the global corporation significant flexibility and overall efficiency. Nevertheless, these benefits often come at a cost. First, there is the complication

of internal control measures. Manipulating transfer prices makes it very difficult to determine the true profit contribution of a subsidiary. Second, morale problems typically surface at a subsidiary whose profit performance has been made worse artificially. Third, because of cultural differences, some subsidiary management's may react negatively to price manipulation. Fourth, there is the concern over local regulations. Subsidiaries, as local businesses, must abide by the rules. Legal problems will arise if the subsidiary follows accounting standards that are not approved by the host government. Indeed, in many countries, transfer pricing practices are often subject to close review by local authorities.

#### Conclusion

Undoubtedly, pricing will continue to gain significance for global companies over the next decade. With intensified competition and interdependence of markets, global managers will find management of prices even more challenging. The challenges will involve attainment of better coordination of worldwide prices by corporate headquarters, achievement of the delicate balance between corporate and local control of prices, quicker response to marketplace changes, avoidance of gray-market or parallel-importing activity and development of alternatives to often costly price competition.

These challenges imply new or improved practices on the part of global companies. For example, an efficient, smooth and rapid system of communication with subsidiary managers or distributors is essential. Those companies that operate in so called global industries, such as tele-

communications, construction equipment, or medical equipment, need to devise efficient mechanisms for monitoring competition worldwide and disseminating relevant information to the members of the corporate family in a timely manner.

Pricing globally also remains an organizational challenge. Increasingly, it is an area in which input from different functional divisions and regions allows for better decisionmaking. Nevertheless, many companies make critical pricing decisions without the necessary consultation with all units concerned.

Pricing executives will also have to develop a better appreciation of the intimate relationships between price and other elements of the marketing mix. Pricing decisions cannot be reached in isolation from other dimensions of the offer, such as product quality, after-sale service, follow-up sales opportunities, credit terms and so on. Price represents only one item in the bundle of benefits perceived by the customer. Interpreting customer's perception of product value continues to be a formidable but necessary task. Pricing decisions that are based on a good

understanding of perceived value—from the perspective of both the intermediaries and the final customers—are more likely to be successful.

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