

## The role of transfer pricing methods to enhance performance evaluation of economic units: An applied study in Alan Group for producing Kawanter

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### Abstract:

The research aimed at identifying the application methods of transfer pricing in Alan Group for producing Kawanter as a sample of the research in order to evaluate performance its two divisions particularly and whole factory through (ROI as a traditional technique and EVA as a new technique) indicator. The problem of the research is the lack of interest in applying transfer pricing methods by economic units in Erbil despite its importance; since the limited application of the transfer pricing in some of the economic units might not help in measuring the performance of economic units. The research relied on deductive approach to define the research problem, the historical approach to review some of the previous studies, and the practical study approach to determine the relevant method at application of transfer pricing, the researcher "Alan Group" was chosen to produce a Kawanter as his research sample to test his hypothesis, due to the possibility of measuring the costs and revenues of each division of the sample for the first half of year 2021, and therefore the possibility of relying on it to measure the return on investment indicator and the added economic value indicator as a tool for evaluating the division's performance individually and the sample in general. The most important findings of the study indicated that different methods of transfer pricing can be used to measure the performance of divisions in "Alan Group" factory as a sample of the research; The most important recommendations of the research call for the multi-divisions of economic units in environmental local to select a method among three methods when applied transfer pricing that suitable with nature of their activity and products for purpose of performance evaluation.

**Keywords:** methods of transfer pricing, performance evaluation (ROI, EVA).

دور طرق التسعير التحويلي في تعزيز تقييم أداء الوحدات الاقتصادية  
دراسة تطبيقية في كروب آلان لإنتاج الكوانتر

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المستخلص:

يهدف البحث إلى التعرف على طرق تطبيق التسعير التحويلي في مجموعة آلان لإنتاج الكوانتر كعينة البحث لتقييم أداء قسميها بشكل خاص والمصنع (كروب) بشكل عام من خلال

مؤشر (ROI كمؤشر تقليدي وEVA كمؤشر جديد). تتمثل مشكلة البحث في عدم الاهتمام بتطبيق طرق التسعير التحويلي من قبل الوحدات الاقتصادية في محافظة أربيل رغم أهميتها، لأن التطبيق المحدود للتسعير التحويلي في بعض الوحدات الاقتصادية قد لا يساعد في قياس أداء الوحدات الاقتصادية. اعتمد البحث على المنهج الاستنتاجي لتحديد مشكلة البحث، والمنهج التاريخي لمراجعة بعض الدراسات السابقة، ومنهج الدراسة العملية لتحديد الطريقة المناسبة عند تطبيق التسعير التحويلي، وتم اختيار الباحث "ألان كروب" لإنتاج كوانتر كعينة لبحثه لاختبار فرضيته، وذلك لإمكانية قياس التكاليف والإيرادات لكل قسم من أقسام العينة للنصف الأول من عام 2021، وبالتالي إمكانية الاعتماد عليها لقياس مؤشر العائد على الاستثمار ومؤشر القيمة الاقتصادية المضافة كأداة لتقييم أداء القسم بشكل فردي والعينة بشكل عام. أشارت أهم نتائج الدراسة إلى إمكانية استخدام طرق مختلفة لتسعير التحويل لقياس أداء الأقسام في مصنع "ألان كروب" كعينة من البحث. وأهم توصيات البحث تدعو الأقسام المتعددة للوحدات الاقتصادية المحلية البيئية إلى اختيار طريقة من بين ثلاث طرق عند تطبيق التسعير التحويلي المناسب لطبيعة نشاطهم ومنتجاتهم بغرض تقييم الأداء.

**الكلمات المفتاحية:** طرق التسعير التحويلي، تقييم الأداء (EVA، ROI).

**A. Introduction:** In a decentralized economic unit, individual divisions hold a lot of decision-making power. Frequently, the divisions interact through supplying one another with goods or services. Top management in these circumstances employs transfer pricing to coordinate divisional efforts and evaluate the effectiveness of their managers. (Datar & Rajan, 2018). Transfer pricing has been a key concern for the larger corporate audience in the last 5 to 10 years. It is described as a method for allocating costs and revenues among divisions, subsidiaries, and joint ventures within a group of connected companies in the most efficient way possible. (Kaur, 2013). In terms of the modern globalized economy transfer prices are one of the important managerial accounting tools needed by the management of multi-divisional economic units, whose production passes through several stages and transfer pricing has also become one of the most important issues faced by financial managers and accountants. Transfer pricing has become a matter of great interest not only for an economic unit's management, but also be can used to improve performance evaluation of divisions that belonged to economic units (Perčević & Hladika, 2017), and the transfer pricing is a problem that arises when large economic units create different divisions inside their economic units in order to reap the benefits of decentralized decision-making. These divisions or units are, for the most part, self-contained profit centers that frequently move and sell goods and services to one another. Transfer pricing is the term used to describe these

transactions. Transfer pricing may have numerous aims and functions, and it is believed that no other business function is as tightly integrated into nearly all corporate operations as transfer pricing. (Hjertberg & Pettersson, 2010). Furthermore, top management performs transfer pricing since they desire divisions that trade internally at a different price than the market price in order to apply price pressure on external suppliers. (Arya & Mittendorf, 2010). In addition, top management considers transfer pricing when deciding whether or not to enable the division to enter new markets. (Cools & Slagmulder, 2009). Benefits distribution that is equitable is a necessary prerequisite for successful relationships to continue. (Dekker, 2004). However, we must consider how the economic unit might give a reasonable profit allocation to the transaction's management. Then, to align the incentives given to managers with their performance, an appropriate pay structure must be established. (Chong & et al., 2018).

- 1. The problem of the study:** The main research problem is represented in what is the role of calculating transfer pricing methods to enhance of the performance evaluation of multi-divisions of economic units of the research sample?

The study problem can be clarified through the following main questions:

- Dose cost-based transfer prices method have a role to enhance the evaluation of the division's performance in particular and economic unit in general of the research sample?
  - Dose market-based transfer prices method have a role to enhance the evaluation of the division's performance in particular and the economic unit in general of the research sample?
  - Dose hybrid transfer prices method have a role to enhance the evaluation of the division's performance in particular and the economic unit in general of the research sample?
- 2. Objective of the study:** The research aims to highlight the importance of using the appropriate method among the three methods (cost-based transfer prices, market-based transfer prices and hybrid transfer prices) between the divisions of the economic unit for the purpose of pricing the outputs transferred or exchanged between them the different activity, which makes the rate of return on investment indicator and economic value added

indicator an appropriate indicators in order to evaluate the efficiency of the performance of the divisions In the multi-divisional economic unit.

**3. Importance of the study:** The importance of the scientific research is that it is concerned with transfer prices, as it is one of the important concepts in managerial accounting, which did not find sufficient attention from researchers, especially with regard to its impact on the performance of local multi-division economic units, where attention is focused on its impact on the performance of multinational economic units and the tax aspects. As for the practical importance, it is represented in the importance of applying transfer prices methods in multi-divisional economic units because it provides a tool that combines financial indicators, including the return on investment index and the economic value-added index as an indicator for evaluating the performance of divisional divisions in a multi-divisional economic unit.

**4. Study hypotheses:** based on the research problem and its objectives, its hypotheses can be formulated as follows: "The main hypothesis of the research is that the application of transfer price methods affects the return on investment indicator and the economic value added indicator of the divisions and the economic unit as a whole as indicators for evaluating performance, and transfer prices as well as providing appropriate information for decision-making on evaluating the performance of units and in the field of justice between divisions in the distribution of incentives. Divided from this hypothesis the following sub-hypotheses:

- The method of cost-based transfer prices has a role to enhance the performance evaluation of the division in particular and the economic unit in general.
- The method of market-based transfer prices has a role to enhance the evaluation of the division's performance in particular and the economic unit in general.
- The method of hybrid transfer prices has a role to enhance the performance evaluation of the division in particular and the economic unit in general.

**5. Study limits:** The study limits include:

- Locative boundaries: The researcher chose Alan Group for produce Kawanter in the governorate of Erbil, a sample was studied in order to arrive at his objective and prove his hypothesis.

- Temporal boundaries: The data in the financial statement of the factory will be used as it is the study sample for the first half of 2021.

**6. Conceptual framework of the study;** Based on the study problem, the independent and dependent variables can be shown as follows:

- Independent variables: Transfer pricing methods: These are those methods that effect to enhance performance evaluation, and it consists of (cost-based transfer prices, market-based transfer prices and hybrid transfer prices) method.

- The dependent variable: Performance evaluation indicators: These are those measures that are affected by transfer pricing methods, and they consist of "Economic Value Added, Return on Investment.

## **B. Literature review:**

**1. Previous Studies:** The study (tono & et al, 2018) aims to discuss the decision of transfer pricing within the corporation across economic units and divisions. Because of the trade-off between personal motivations and the best interests of the economic units as a whole, a conflict of interest between divisions or economic units is common. The key to overcoming the conflict of interest that emerges in transfer pricing is the use of specific performance measurement methods and the position of the top manager. Transfer pricing can be done in a variety of ways, each with its own set of advantages and disadvantages. Nonetheless, a conflict of interest in transfer pricing is a common issue. Because most performance evaluations are focused on the profit generated. Chong & et al. (2018) has examined that in this paper leadership tone and performance assessment schemes are two control measures that corporations might use to avoid negotiating conflicts in negotiated transfer pricing choices. A supportive leadership tone increases the likelihood that divisions will compromise on a transfer price close to the equal-profit transfer price when division managers are evaluated using a competitive performance evaluation method. In contrast, when division managers are evaluated using a cooperative performance evaluation scheme, however, leadership tone has no effect on whether divisions compromise on an equal-profit transfer price. These findings show that in a decentralized economic unit structure with individual performance evaluations, economic units can employ an informal control such as leadership tone to handle negotiation problems. Takács (2013) the purpose of this study is to find out how transfer pricing (TP) affects the

major management control functions of economic unit, planning, evaluating, and rewarding. The main finding of why TP had such an impact was the lack of a common enterprise resource planning system, which resulted in a lack of internal transparency of the TP policy. Furthermore, because to an uneven distribution of authorized economic unit resources, the TP impact was perceived and managed differently among sub-units and sectors. Boro, (2013) The objective of the study was to determine the transfer pricing techniques adopted by Multinational companies in Kenya and also to determine the level of transfer pricing techniques implementation by Multinational companies in Kenya. A survey research design was used. The study findings majority indicated that the most commonly used transfer pricing techniques is cost-based transfer pricing and that the most approach to resolving the transfer pricing conflicts is that goods can be transferred between the divisions at a variable cost with profit to the supplier provided by a periodic charge. The study recommends that multinational companies should consider implementation the transfer pricing techniques to minimize the associated costs and that the challenges involved in transfer pricing techniques should be taken in to consideration by the concerned management team to reduce the unplanned losses that may occur during implementation phase.

After presenting some of the previous studies which is regarding to the subject of the research in titled "The role of transfer pricing methods to enhance performance evaluation of economic units", it appeared to the researcher that there are points of similarity between the title of the research and the previous studies, but the current research focuses on how to choose the method from the three methods of the transfer price between the division's management of the economic unit with multi-divisions that is suited with 1. The nature of the unit's activity in general and the division in particular, 2. The conditions in the surrounding local environment in which the division and unit are lived, 3. The strategy of each division which is followed, in order to improve the efficiency of the management performance of each division of the economic unit through using two indicators are (ROI and EVA).

- 2. Concept of transfer pricing and its important:** Much of the decision-making authority in a decentralized economic unit is concentrated in its separate divisions. Frequently, the divisions interact through supplying one

another with commodities or services. Top management in these circumstances employs transfer pricing to coordinate divisional efforts and evaluate the effectiveness of their managers. (Datar & Rajan, 2018). Transfer pricing systems in multidivisional firms focus on the maximization of divisional income, leading the divisions to achieve their goals through sub-optimization (Brychta & et al. 2020). Basically, the price that one division of an organization sets to sell items or services to another division of the same economic unit is known as the transfer price. (Trang 2016). A transfer pricing system should achieve three goals: accurate performance evaluation, goal congruence, and divisional autonomy protection. When it comes to accurate performance appraisal, no one divisional manager should gain at the price of another (in the sense that one division is made better off while the other is made worse off). Divisional managers choose activities that increase firmwide earnings, which are known as goal congruence. Central management should not interfere with divisional managers' decision-making autonomy, according to autonomy. Finding a solution that meets all three objectives at the same time is the transfer pricing challenge. (Hansen & Mowen, 2006). Although there is no optimal transfer price that meets all specified objectives, there is a basic rule for transfer pricing, Horngren et al. (2014) as a reasonable benchmark for guidance, a general guideline for transfer price was offered. Specifically, "Transfer price=Outlay cost (Incremental Cost) + Opportunity cost (Margin that division's selling is forgone when sell units internally)" In this formula, outlay cost is the amount of money the producing division has to pay to produce the product or service, and "opportunity cost is the contribution to profit that the producing division forgoes by transferring the item internally" (Horngren & et al., 2014). The opportunity cost approach determines the lowest price a selling division is willing to accept and the highest price a buying division is willing to pay. The opportunity costs of internal transfers are represented by these minimum and maximum prices. They are defined for each division as follows: (Hansen & Mowen, 2006), 1. The minimum transfer price, often known as the floor, is the price at which the selling division will not be harmed if the good is sold to an internal division, 2. The maximum transfer price, also known as the ceiling, is the transfer price at which the buying division will not be harmed if an input is purchased from within the company. When it is possible to raise firmwide

profitability through internal transfers, the opportunity cost rule communicates this. Specifically, when the selling division's opportunity cost (minimum price) is less than the buying division's opportunity cost (maximum price), a good should be transferred internally. By its very definition, this method assures that the divisional manager of either division does not suffer as a result of the internal transfer. This means that the internal transfer has no effect on total divisional profitability. Assume that the transfer price in the previous formula is X The buying division will take the maximum transfer price if it is the lesser of two values, whereas the producing division will accept X as the minimum transfer price, the highest transfer price will be acceptable to the buying division when it is the lesser of two values, the difference between the ultimate customer's selling price and other cost the division must cover to finish and sell the goods, as well as the cost charged by an outside supplier. In the meanwhile, because X fits all of the above criteria, the transfer decision will be favorable to the company when the overall costs of manufacturing the item internally are less than its value, and the costs incurred by the producing division are less than the selling price of the item from an outside supplier, when the outside supplier price is less or more than X, X can provide similarity in best options between divisions and the company. (Table 1). (Horngren et al., 2014)

Table (1) effects of Transfer Price (assume with the value of X) on Decisions

Outside Supplier price	Best Decision for Division	Best Decision for Company
Less than X	Do not transfer - the buying division refuses to transfer because doing so would harm its revenues	Do not transfer; instead, purchase from a supplier because it is less expensive for the organization as a whole
Greater than X	Both the selling and buying divisions profit from a transfer at X Do not transfer if the value to the buying division is less than X - the buying division will reject the transfer	Internal production has a lower cost than buying from outside sources Do not transfer—the cost of manufacturing internally is larger than the value of the company's products

As for the purposes and mechanics of transfer pricing, there are four main reasons for instituting a transfer pricing scheme: (Heath & et al., 2008), 1. Create distinct profit statistics for each division and evaluate each division's performance separately, 2. Assist in coordinating the various divisions' production, sales, and pricing decisions (via an appropriate choice of transfer prices). Managers are made aware of the value of goods and services for other divisions of the company via transfer prices, 3. The company can create profit (or cost) figures for each segment separately using transfer pricing and 4. Not only will the transfer price have an impact on each center's reported profit, but it will also have an impact on how a company's resources are allocated. With regard to mechanics of transfer pricing that, 1. There is no requirement for money to be exchanged between the two groups. The transfer fee may only be utilized for internal purposes, 2. (Transfer Price  $\times$  quantity of items transferred) is a cost for the buying center and a profit for the selling center.

#### **Methods of Transfer Prices:**

Central management rarely sets specific transfer prices. Rather, most economic entities adopt a set of general policies that all divisions must adhere to. There are three broad categories of methods top managers can use to determine transfer prices (Market-based transfer prices, Cost-based transfer prices and Hybrid-based transfer prices). "Besides these methods, there is a dual transfer pricing method to those accounting transfer pricing methods. Perčević & Hladika (2017) specified the advantages of dual transfer pricing methods, as well as the consequences which may appear from the usage of dual transfer pricing methods. The key point of transferring goods and services within a related economic unit or within a group is not the transfer price charged in the transaction"; they are as:

- ❖ **Market-based transfer prices:** Transferring products or services at market prices generally leads to optimal decisions when three conditions are satisfied follows (Datar & Rajan, 2018): (1) The intermediate product market is extremely competitive, (2) subunit interdependencies are minor, and (3) there are no additional costs or benefits to the corporation as a whole from purchasing or selling on the open market rather than dealing internally. The correct transfer price is the market price if there is an outside market for the intermediate product that is perfectly competitive. In such a case, the acts of divisional managers will maximize divisional

profits as well as firmwide profits. Furthermore, no division can gain an advantage at the expense of another. Central management will not be tempted to intervene in this situation. The opportunity cost approach also indicates that the market price is the optimal transfer price. Because the selling division can sell whatever it makes at market price, transferring internally at a lesser price would be detrimental to that division. Similarly, because the purchasing division can always get the intermediate good at market price, it would be unlikely to pay extra for an internally transferred good. Because the market price is the selling division's minimum transfer price and the buying division's maximum transfer price is also the market price, the market price is the only conceivable transfer price. In fact, deviating from the market price reduces the firm's overall profitability. This principle can be utilized to address potential divisional conflicts. (Hansen & Mowen, 2006). When the price for the intermediary product or service is quoted on both a long-term contract and a spot market basis, however, conflict may arise. The transfer pricing problem gets much more problematic when the market is not totally competitive, as it is for most produced items. Furthermore, there is a tension between short-term and long-term issues. In order to buy into the firm, an external vendor may quote a cheap price with the intention of boosting pricing later. Normally, the company should not switch its source of supply from an internal unit to an outside company unless it is satisfied that the outside company will be able to keep the specified price for an extended length of time. Shortly, none of the proposed solutions to the problem of transfer pricing, including market-based transfer pricing, are ideal. (Garrison & Noreen, 2000).

- ❖ **Cost-based transfer prices:** When market prices are unavailable, incorrect, or prohibitively expensive, cost-based transfer pricing can be useful. This can happen in a variety of situations, including when markets aren't totally competitive, when the product is specialized, or when the internal product differs from externally available items in terms of quality and customer service. Top managers may set a transfer price depending on the cost of producing the transferred product. Variable production costs, variable and fixed production costs, and the total cost of the product are all examples. The full cost of the product includes all production costs plus costs from other business functions (R&D, design, marketing, distribution, and customer service). Actual or budgeted costs can be utilized to calculate

cost-based transfer pricing. A markup or profit margin that represents a return on subunit investment is sometimes included in the cost-based transfer price. (Datar & Rajan, 2018)

- **Variable Cost:** Variable cost-based pricing approach is useful when the selling division is operating below capacity. This transfer price will often irritate the management of the selling division because it generates no profit for that division. Only variable production costs are passed in this pricing method. Direct materials, direct labor, and variable factory overhead are included in these costs. The main benefit of variable cost is that it encourages maximum profitability for the entire company. Production and pricing decisions are based on cost-volume-profit correlations for the economic unit as whole when only variable costs are passed on to the next division. The obvious issue is that the selling division is responsible for all of the company's fixed costs and operating expenses. That division is currently a loss center, not even close to becoming a profit center. One solution is for the selling division to make a lump-sum transfer payment to cover fixed costs while also generating some operating income. The fixed payment is the cost to the buying division of using the selling division's capacity. If the fixed price is negotiable, variable cost plus fixed fee can be a helpful transfer pricing strategy. The revenue generated by each division can then be used to assess each division's and manager's performance. (Hansen & Mowen, 2006).

- **Actual Full Cost plus Profit Margin:** In actual full cost approach, the transfer price is determined by the total cost per unit of the finished product, which includes direct material, direct labor, and factory overhead. The selling division cannot make a profit on the goods transferred when full cost is applied for transfer pricing. This could be a deterrent to the selling division. Furthermore, full cost transfer pricing has the potential to create perverse incentives and distort performance measures. Any potential of divisions negotiating about selling at transfer prices would have been eliminated if the full cost transfer price had been used, to overcome this problem the supplying division is frequently allowed adding a mark-up in order to make a "reasonable" profit. The transfer price may then be viewed as an approximate market price (Heath & et al., 2008).

There is a problem with measuring cost in actual cost approaches. Actual cost provides little motivation for the selling division to keep costs

under control. All product costs are passed on to the buying division. Any discrepancies or inefficiencies in the selling division are passed on to the buying division while transferring actual cost. Isolating deviations that have been transmitted to consecutive buyer division becomes a very difficult challenge. Standard costs are typically used as a basis for transfer pricing in cost-based systems to promote responsibility in the selling division and to isolate differences within divisions. Standard costs, when available, are frequently used as the foundation for transfers, whether at differential costs or full costs. Because inefficiencies are not passed on to the buying division, this increases efficiency in the selling division. Otherwise, cost inefficiencies in the selling division can be passed on to the buying division. The buyer's risk is reduced when standard costs are used. The buyer is aware that normal costs will be transmitted, and thereby avoids being charged for cost overruns by suppliers.

❖ **Hybrid-based transfer prices:** One the most common of hybrid methods is negotiated pricing. Top managers do not distribute a specified split of the final profits across the transacting divisions under this strategy. Rather, the final transfer price is determined by a negotiation between the selling and buying divisions. (Datar & Rajan, 2018), and competitive markets rarely exist. In most cases, when market flaws exist for the intermediate product, producers can influence pricing; nevertheless, market price may no longer be appropriate. Negotiated transfer prices may be a viable option in this circumstance. Opportunity costs can be used to determine the negotiation set's bounds. (Hansen & Mowen, 2006). This method preserves the autonomy of the units and is in line with the decentralization management style's goal. Second, the unit's managers are more likely than others in the company to have a much greater understanding of the prospective costs and benefits of the move. (Talha & et al. 2005). Despite division autonomy, division managers are motivated to increase their divisions' operational income. However, according to surveys, about 15–20 percent of businesses negotiate transfer prices. Firms that do not use negotiated prices argue that the time and effort needed by managers negotiating transfer prices makes the approach excessively expensive. (Datar & Rajan, 2018). The transfer price between the transacting division (selling and buying) can be clarified through the following through assumption is graphically presented in Figure 2A and Figure 2B respectively (Garrison and Noreen, 2000);

Figure 2A:  $\longrightarrow$  Selling Unit's Minimum Acceptable Transfer Price

"Transfer price  $\geq$  Variable cost per unit + Total Contribution margin on lost sales number of units transferred"

Figure 2B:  $\longrightarrow$  Purchasing Unit's Maximum Acceptable Transfer Price

"Transfer price  $\leq$  Cost of buying from outside supplier"

The researcher concluded from the previous three methods that the transfer pricing method should be chosen in such a way that it benefits both the economic units as a whole and the organizational parties. Frequently, the choice of the method is connected with the motivation and autonomy of profit (or investment) center managers and their maximum coordination that market-based transfer pricing. Under this method, the intercompany prices are established by reference to the market (e.g., at what prices external vendors sell respective products or services). Cost-based transfer pricing, this method uses internal cost data to establish transfer pricing. There are multiple ways of using costs when applying this method (e.g., variable cost only, variable and fixed fee, full cost + mark-up).

Hybrid transfer pricing, this method is applied when there is no clear external market-based pricing and cost-based transfer pricing is not possible. The selling and buying division of a company negotiate the transfer prices.

### **3. Concepts and importance of performance evaluation and (ROI & EVA):**

A performance evaluation is an unavoidable element of organizational life. There are many decisions in modern economic units, especially multi-division's units that depend on performance evaluations, and they are widely used in most economic units. They are a crucial part of the process by which economic units strive to direct themselves, and they have been seen as a critical component in economic unit success for much of the twentieth century. Performance evaluation allows economic unit to inform their division about their rates of growth and continued in the competitive environmental local (Cintrón, 2011).

Performance evaluation has been described as "the process of identifying, observing, measuring, and developing human performance in organization". This definition is very important, because it comprises all important components needed for the well-performed appraisal process (Dechev, 2010). Performance evaluation plays a very important role in

growth and development of any organization it is a way to communicate about the financial health of the organization with users of financial reporting like investors, customers, suppliers, government, institutional investors, and employees because it impacts on goal congruence, motivation and employee effort, therefore it is very important to rightly measure the financial performance. To measure performance evaluation of divisions and economic unit as a whole, there are many indicators can be used; such EVA and ROI. EVA can be taken as the net operating profit minus an appropriate charge for the opportunity cost of all the capital invested in a company. EVA is a measure of actual economic profit, or the amount by which earnings exceed or fall short of the needed minimum rate of return those shareholders and lenders may obtain by investing in other assets with comparable risk. (Mohammed, 2021). EVA is a value-based financial performance measure, an investment selection tool, and a performance measure indicating the absolute amount of shareholder value created (as a modern technique). It's calculated by multiplying the "excess return" on an investment or investments by the money invested in those assets. EVA is net operating profit minus a charge for the opportunity cost of all capital invested in a business or project. It's a calculation of genuine economic profit, or the amount by which earnings exceed or fall short of the needed minimum rate of return those investors may get by investing in similar risky securities. (Geysler & Liebenberg, 2003). Economic value added is the difference between NOPAT and Capital charge (Talreja, 2020)

$$EVA^{\circledast} = \text{Net Operating Profit after Tax (NOPAT)} - \text{Capital Charge}$$

**Where,** NOPAT = Net Operating Profit = Income- Operating Expenses - Tax  
 Capital Charge (Cost of capital) = Total Capital Invested (Employed) \*  
 Weighted average cost of capital.

Total capital invested = Total Assets – Current Liabilities.

Weighted Average cost of Capital = Cost of Debt (Weighted of Debts \* interest after tax) + Cost of Equity (Weighted of Equity \* Average cost of equity).

Whereas, return on investment as a traditional technique is a performance notion that may be applied to any type of investment. The ultimate goal of the company is stated in return on investment (ROI) for shareholders. The return on investment (ROI) is an indicator that measures how much profit a company makes from the capital it invests. It displays

how much of the money spent on a certain action pays off in terms of profit or loss. Thus, it enables efficiency assessment of an amount invested or, in other words, ROI allows measuring the result in relation to the means used to obtain it. ROI is calculated with the following equation (Zamfir & et al, 2016):

$$\text{Return on Investments (ROI)} = \frac{\text{Net Operating Profit after Tax}}{\text{Total Assets or Investments}}$$

**C. Case study: show the financial statement factory and its description:**

**An description of the sample of the research and its financial statement:** The researcher, Alan Group for producing "Kawanter" a multi-division was chosen as a sample of his research in order to prove his hypothesis and achieve its goals, as the factory is considered one of the eligibility factories in the local environment and has two division. First is called HDF Division where produces HDF (high density fiberboard) wood, which consists of mixing the chemical material and natural wood, resulting from the low proportion of the chemical and the high density of natural wood, which is of high quality and in different colors. It is a durable wood that lives for several years; the division was working at 89% of its capacity, which is equivalent to approximately "2015" meter per length of HDF. As for the compositions of the product, where each meter of HDF needs "3" liters of a specific chemical material and "1.5" k/g of natural wood, where the price of the chemical per liter was "\$16" and the price of a kilo of wood was "\$15". It is the final product of the division and a raw material for the second division is called Kawanter division where produces the Kawanter using aluminum frame with HDF wood doors, the division was working at 80% of its capacity approximately, and the components of each meter per length of the product were up to "10" meters of aluminum at a price of "\$3" per meter and a meter per length of HDF and its price is 116% of total cost finished goods, in accordance with the group manufactures its products with standard specifications to meet the needs of consumers in the Kurdistan region of Iraq. Therefore, the researcher has classified the cost elements of the two divisions into direct material costs, which are represented by the cost of material chemical and woods for HDF division and HDF & aluminum for Kawanter division, labor costs, which are represented by direct and indirect worker in division, manufacturing overhead cost. Table No. (2) (3) shows a statement of the distribution of costs to two divisions for the first half of year 2021 as follows:

Table (2): cost of material chemical and wood purchased for HDF division for the 1<sup>st</sup> half of 2021

Details	HDF (2015 m/l)	Total	Cost per unit
1 <sup>st</sup> direct material:			
Number of chemical material purchased in litter	6045 litter		
(×) Purchasing price per litter (\$)	16		
= Cost of chemical material purchased (\$)	96720		
2 <sup>nd</sup> direct material:			
Number of wood nature in Kilo (Kg)	3022.5 (kg)		
(×) Purchasing price per (kg) (\$)	15		
= Cost of wood nature purchased (\$)	45337.5		
Total direct material cost		142057.5	70.5
Direct Workers cost (8 worker × 440\$ × 6 months )		21120	10.48
Design Cost		1007.5	0.5
Manufacturing overhead:			
Indirect material (fuels, oils, gum and etc.) <sup>1</sup>	1610		0.8
Indirect labors (manager, supervisor, guard, cleaner) <sup>2</sup>	8600		3.8
Depreciation <sup>2</sup>	1990		0.88
Rent (600\$ per month × 6 months) <sup>2</sup>	3600		1.6
Other Expenses (water, electricity, internet, etc.) <sup>3</sup>	1530		0.72
Total cost of manufacturing overhead		17330	7.8
Total cost of finished goods (HDF)		<b>181515</b>	<b>89.28</b>

1: All of indirect material is variable, 3: amount 885\$ are variable, 2: available capacity 2265 m/l according to records of the division.

Table (3): cost of aluminum and HDF for Kawanter division for the 1st half of 2021

Details	Kawanter (1800 m/l)	Total	Cost per unit
1 <sup>st</sup> direct material:			
Number of aluminum purchased in meter per length	18000 m/l		
(×) Purchasing price per litter (\$)	3		
= Cost of aluminum purchased (\$)	54000		
2 <sup>nd</sup> direct material:			
Number of HDF (m/l)	1800 m/l		
(×) Purchasing price per (kg) (\$) (89.28 × 116%)	103.6		
= Cost of HDF purchased (\$)	186480		
Total direct material cost		240480	133.6
Direct Workers cost (10worker × 430\$ × 6 months )		25800	14.33
Design Cost in average		1080	0.6
Manufacturing overhead:			
Indirect material (fuels, oils, silicon and etc.)	1045		0.58
Indirect labors (manager, supervisor, guard, cleaner)	9000		4
Depreciation	1115		0.5
Rent (500\$ per month × 6 months)	3000		1.33
Other Expenses (Water, Electricity, Internet, etc.) <sup>1</sup>	1770		0.9
Total cost of manufacturing overhead		15930	7.31
Total cost of finished goods (Kawanter)		<b>283290</b>	<b>155.84</b>

1: amount 990\$ of 1770 is variable.

As for the statement of financial position for each division, the researcher took the data from the records of each division of Alan Group at the end of the year 2020, Table No. (4) Shows a statement of financial position as follows:

Table (4): Financial Positing Statement for HDF and Kawanter Division at end of June, 2021

Details	HDF Division		Kawanter Division	
	Partial	Total	Partial	Total
Assets:				
Cash	23000		52100	
Cash in bank	19500		19000	
Account Receivable	13320		29540	
Inventories	24500		-----	
Total Current Assets		80320		100640
Tools & Equipment	85000		98500	
(-) Accumulative depreciation	(25500)		(25500)	
Book Value of Tools & Equipment	59500		73000	
Cars	45000		74000	
(-) Accumulative depreciation	(18000)		(20200)	
Book Value of Cars	27000		53800	
Furniture	4200		3900	
(-) Accumulative depreciation	(2100)		(1500)	
Book Value of Furniture	2100		2400	
Total Fixed Assets		88600		129200
<b>Total Assets</b>		<b>168920</b>		<b>229840</b>
Liabilities & Owner's Equity				
Account Payable	24520		14550	
Accrued Expenses	1025		4910	
Bank loans with annual interest 8%	28000		24500	
Total Liabilities		53545		43960
Owner's Equity		115375		185880
<b>Total Liabilities &amp; Owner's Equity</b>		<b>168920</b>		<b>229840</b>

**Note:**

- The researcher made an assumption average cost of owner's equity is 12%, because there is no effective financial market in the place of the research sample and choosing this rate because it is close to reality and similar to the average of companies in the same activity. 2) Income Tax rate is 15% according to income tax authorities.
- Apply the independent variable and dependent variable of case study; in this section the researcher will test his hypothesis on data of the division, as the follows;

**"First sub-hypothesis: The method of cost-based transfer prices has a role to enhance the performance evaluation of the division in particular and the economic unit in general".**

The researcher shows the effect of cost-based transfer prices method on performance evaluation of the two divisions by using ROI and EVA indicators as shown in table (5):

Table (5): Division Operating income for two divisions according to cost-based transfer pricing

Details	Cost-based transfer pricing method			
	Full-cost + mark-up (110%)		Variable-cost + mark-up (115%)	
	Partial	Total	Partial	Total
<b>Selling Division (HDF);</b>				
Sales Revenue (1800 × 98.208\$), (1800 × 95.128\$) <sup>1</sup>		176774.4		171230.4
(-) Cost;				
Direct Material:				
Chemical Material (1800 × 3 litter × 16\$)	86400		86400	
Wood Nature (1800 × 1.5 kg × 15\$)	40500		40500	
Total direct material	126900		126900	
Direct worker cost (1800 × 10.48)	18864		18864	
Design Cost (1800 × 0.5)	900		900	
Total Manufacturing overhead <sup>2</sup> :	17067		17067	
Total division cost		(163731)		(163731)
Division operating income		<b>13043.4</b>		<b>7499.4</b>
<b>Buying division (Kawanter)</b>				
Sales Revenue (1800 × 170\$)		306000		306000
(-) Cost;				
Transfer-in cost	176774.4		171230.4	
Aluminum	54000		54000	
Direct worker cost	25800		25800	
Design Cost in average	1080		1080	
Total Manufacturing overhead	15930		15930	
Total division cost		(273584.4)		(268040.4)
Division operating income		<b>32415.6</b>		<b>37959.6</b>
<b>Operating income of both divisions together</b>		<b>45459</b>		<b>45459</b>

1:  $(89.28\$ \times 110\% = 98.208\$)$ ,  $\{(70.5 + 10.48 + 0.5 + 0.8 + 0.44) \times 115\% = 95.128\}$ .

2: (indirect material =  $0.8 \times 1800$  + indirect labor = 8600 + depreciation = 1990 + rent = 3600 + other exp. = " $0.44 \times 1800 + 645$ ").

Applying ROI and EVA on the data of the two divisions for purposing performance evaluation according to method of cost-based transfer pricing, as shown in table (6) and (7):

Table (6): Applying ROI and EVA for divisions

Indicators	HDF division		Kawanter division	
	Full-Cost	Variable-Cost	Full-Cost	Variable-Cost
1) ROI:				
Sales Revenue	176774.4	171230.4	306000	306000
(-) manufacturing cost	(163731)	(163731)	(273584.4)	(268040.4)
Gross profit	13043.4	7499.4	32415.6	37959.6
(-) Operating Expenses <sup>1</sup>	(1136)	(1136)	(5944)	(5944)
Operating profit before tax	11907.4	6363.4	26471.6	32015.6
(-) Income tax (15%)	(1786.11)	(954.51)	(3970.74)	(4802.34)
Net Operating Profit after Tax	10121.29	5408.89	22500.86	27213.26
÷ Total Assets	168920	168920	229840	229840
= ROI	6%	3.2%	9.8%	11.8%
2) EVA:				
Net Operating Profit after Tax	10121.3	5408.9	22500.86	27213.26
(-)Capital Charge (Cost of capital):				
Total capital invested <sup>2</sup>	143375	143375	210380	210380
× Weighted Average cost of Capital <sup>2</sup>	0.1102	0.1102	0.1139	0.1139
Capital Charge (Cost of capital)	(15800)	(15800)	(23962.3)	(23962.3)
= EVA	(5678.7)	(10391.1)	(1461.4)	3251

1: the figures were taken from records and statements of the division.

2: Capital invested = total assets – current liabilities.

It is noted that the EVA gives a negative result that means the two divisions consume the invested capital more than the profit of the operations, and this negatively affects the wealth of the owners, it is a fact that should not be lost on any investor who has awareness and understanding in investing in various fields.

Table (7): Calculating of weighted average cost for divisions

<sup>2</sup> Details	Amount	Weighted (1)	After tax cost(2)	Weighted average cost(3)= 1 × 2
<b>HDF division:</b>				
Bank Loans	28000	19.5%	$0.08 \times 85\% = 0.068$	0.0136
Owner's Equity	115375	80.5%	0.12	0.0966
Total	143375	100%		0.1102
<b>Kawanter division:</b>				
Bank Loans	24500	11.6%	$0.08 \times 85\% = 0.068$	0.007888
Owner's Equity	185880	88.4%	0.12	0.106
Total	210380	100%		0.1139

**"Second sub-hypothesis: The method of market-based transfer prices has a role to enhance the evaluation of the division's performance in particular and the economic unit in general".**

The researcher shows the effect of market-based transfer prices method on performance evaluation of the two divisions by using ROI and EVA indicators as shown in table (8):

Table (8): Division Operating income for two divisions according to market-based transfer pricing

Details	Market-based transfer pricing method	
	Partial	Total
<b>Selling Division (HDF);</b>		
Sales Revenue (1800 × 115\$)		207000
(-) Cost:		
Direct Material:		
Chemical Material (1800 × 3 litter × 16\$)	86400	
Wood Nature (1800 × 1.5 kg × 15\$)	40500	
Total direct material	126900	
Direct worker cost (1800 × 10.48)	18864	
Design Cost (1800 × 0.5)	900	
Total Manufacturing overhead:	17067	
Total division cost		(163731)
Division operating income		<b>43269</b>
<b>Buying division (Kawanter)</b>		
Sales Revenue (1800 × 170\$)		306000
(-) Cost:		
Transfer-in cost	207000	
Aluminum	54000	
Direct worker cost	25800	
Design Cost in average	1080	
Total Manufacturing overhead	15930	
Total division cost		(303810)
Division operating income		<b>2190</b>
Operating income of both divisions together		<b>45459</b>

Applying ROI and EVA on the data of the two divisions for purposing performance evaluation according to method of market-based transfer pricing, as shown in table (9):

Table (9): Applying ROI and EVA for divisions

Indicators	HDF division		Kawanter division	
1) ROI:				
Sales Revenue	207000		306000	
(-) manufacturing cost	(163731)		(303810)	
Gross profit	43269		<b>2190</b>	
(-) Operating Expenses	(1136)		(5944)	
Operating profit before tax	42133		(3754)	
(-) Income tax (15%)	(6320)		----	
Net Operating Profit after Tax		35813		(3754)
÷ Total Assets		168920		229840
= ROI		21%		(1.6%)
2) EVA:				
Net Operating Profit after Tax		35813		(3754)
(-) Capital Charge (Cost of capital):				
Total capital invested	143375		210380	
× Weighted Average cost of Capital	0.1102		0.1139	
Capital Charge (Cost of capital)		(15800)		(23962.3)
= EVA		20013		(27716.3)

**"Third sub-hypothesis: The method of hybrid-based transfer prices has a role to enhance the evaluation of the division's performance in particular and the economic unit in general".**

The researcher shows the effect of hybrid-based transfer prices method on performance evaluation of the two divisions by using ROI and EVA indicators as shown in table (10):

Table (10) Division Operating income for two divisions according to hybrid-based transfer pricing

Details	Hybrid-based transfer pricing method	
	Partial	Total
Selling Division (HDF);		
Sales Revenue (1800 × 109\$)		196200
(-) Cost;		
Direct Material:		
Chemical Material (1800 × 3 litter × 16\$)	86400	
Wood Nature (1800 × 1.5 kg × 15\$)	40500	
Total direct material	126900	
Direct worker cost (1800 × 10.48)	18864	
Design Cost (1800 × 0.5)	900	
Total Manufacturing overhead:	17067	
Total division cost		(163731)
Division operating income		<b>32469</b>

Buying division (Kawanter)		
Sales Revenue (1800 × 170\$)		306000
(-) Cost;		
Transfer-in cost	196200	
Aluminum	54000	
Direct worker cost	25800	
Design Cost in average	1080	
Total Manufacturing overhead	15930	
Total division cost		(293010)
Division operating income		<b>12990</b>
Operating income of both divisions together		<b>45459</b>

Applying ROI and EVA on the data of the two divisions for purposing performance evaluation according to method of hybrid-based transfer pricing, as shown in table (11):

Table (11) Applying ROI and EVA for divisions

Indicators	HDF division		Kawanter division	
1) ROI:				
Sales Revenue	196200		306000	
(-) manufacturing cost	(163731)		(293010)	
Gross profit	32469		<b>12990</b>	
(-) Operating Expenses	(1136)		(5944)	
Operating profit before tax	31333		7046	
(-) Income tax (15%)	(4700)		(1057)	
Net Operating Profit after Tax		26633		5989
÷ Total Assets		168920		229840
= ROI		15.7%		2.6%
2) EVA:				
Net Operating Profit after Tax		26633		5989
(-) Capital Charge (Cost of capital):				
Total capital invested	143375		210380	
× Weighted Average cost of Capital	0.1102		0.1139	
Capital Charge (Cost of capital)		(15800)		(23962.3)
= EVA		10833		(17973.3)

Table (12) showing results of three methods with their ROI and EVA indicators for divisions

Indicators	Cost-Based Method				Market-Based Method		Hybrid-Based Method	
	Full-Cost		Variable-Cost		HDF	Kawanter	HDF	Kawanter
	HDF	Kawanter	HDF	Kawanter				
ROI	6%	9.8%	3.2%	11.8%	21.6%	(1.6%)	15.7%	2.6%
EVA	(5678.7)	(1461.4)	(10391.1)	3251	20013	(27716.3)	10833	(17973.3)

The researcher noticed from previous analyzing, that the operating income of the HDF division is \$30225.6 more (\$43269 - \$13043.4) if transfer prices are based on market prices rather than on 110% of the full cost. Correspondingly, the operating income of the Kawanter division is \$30225.6 lower (\$32415.6 - \$2190) if transfer prices are based on market prices rather than 110% of the full cost and so far the variable cost, the operating income of the HDF division is \$35769.6 more (\$43269 - \$7499.4) if transfer prices are based on market prices rather than on 115% of the variable cost.

Correspondingly, the operating income of the Kawanter division is \$35769.6 lower (\$37959.6 - \$2190) if transfer prices are based on market prices rather than 115% of the variable cost. If the HDF division's sole criterion were to maximize its own operating income, it would favor transfer prices at market prices this leads to an increase in the ROI by 21.6% and an increase in the EVA by an amount 20013\$ comparable to the two methods, based on the results of analyzing in table (7) and (8), the researcher can confirm the validity of accepting the second hypothesis which states: "The method of market-based transfer prices has a role to enhance the performance evaluation of the division in particular and the economic unit in general".

In contrast, the Kawanter division would prefer transfer prices at 110% of full cost and 115% of variable cost to maximize its own operating income and this leads to an increase in the ROI by 9.8% & 11.8% comparable to two methods and for the EVA indicator gives an positive amount by 3251\$ for variable cost method but the indicator gives an negative figure by amount (10391.1\$), so through the results of the analysis in table (4) and (5), it becomes clear to the researcher can confirm the validity of proving the first hypothesis which states: "the method of cost-based transfer prices has a role to enhance the performance evaluation of the division in particular and the economic unit in general". The hybrid transfer price of \$109 is between the 110% of full cost & 115% of variable cost and market-based transfer prices is 115\$. It splits the \$45459 of operating income equally between the divisions. This price could arise as a result of negotiations between the HDF and Kawanter division managers, based on the results of analyzing in table (9) and (10), the researcher can confirm the validity of accepting the third hypothesis which states: "The

method of hybrid-based transfer prices has a role to enhance the performance evaluation of the division in particular and the economic unit in general".

**D. Conclusion:** In conclusion, it has been concluded that transfer pricing is common practice in highly diversified companies multi-division, transfer pricing can be determined by several methods such as market-based, cost-based, and hybrid-based. Each method has its own advantages and disadvantages. During our analyzing on data of research sample appeared that method of market-based transfer pricing is suitable method for selling division "HDF division" in case the market for its intermediate product is perfectly competitive, and our application on data of the two divisions leads to maximization operating profit amount 43269\$, as a result, it leads to increasing ROI by 21% and a positive figures 20013\$ compare to purchasing division "Kawanter", in contrast, the method of cost-based transfer pricing is suitable method for purchasing division "Kawanter division" when markets are not perfectly competitive, when the product is customized, or when the internal product differs from externally available products in terms of quality and customer service given, and application leads to maximization operating profit amount 32415.6\$ & 37959.6\$ according to full cost and variable cost respectively, as a result, leading to increasing ROI by 9.8% & 11.8% and a positive figures with 3251\$ compare to selling division "HDF". As for hybrid-based method, it is relevant method when imperfections exist in the market for the intermediate product, market price may no longer be suitable. In this case, negotiated transfer prices may be a practical alternative between selling division and purchasing division, in which the figure of profit, ROI and EVA is located between the two prior methods. In terms of the research sample as a whole, we noted that the total of operating profit according to three methods of transfer pricing is equal, in which 45459\$.

**E. Future Research:** In future research, I'm attempting to conduct research on the impact of many elements such as legal, political, social, internal, and external economic aspects in the selection of transfer pricing methods, as well as the most important determinants determining the method that multi-division economic units utilize.

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