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TRANSFER PRICING RISK WITHIN AUTOMOTIVE INDUSTRY IN THAILAND

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ABSTRACT

The purpose of this study is to assess transfer pricing risk within the automotive industry in Thailand based on COSO ERM 2017; identifying transfer pricing risk, prioritizing risk by rating its severity, and developing appropriate risk response to mitigate risk. The findings and results of this study show that there are five potential key transfer pricing risks sorted by the severity of risk in descending order from intellectual property, profit allocation in accordance with the risk-bearing function and capital, high-risk transaction related to service, arm's length price calculation, and pricing policy and interest. The most efficient and sustainable method to mitigate risk is to understand the business so that the most suitable pricing policy can be selected and embedded into the business plan. In addition, all firms should anticipate auditing from the Thai Revenue Department by regularly reviewing the pricing policy. Another effective risk response for the companies with changes in functions or business structure is to agree on the profit range and pricing policy in advance with the Thai Revenue Department. It is called the Advance Pricing Agreement.

Disciplinary: Management Science (Pricing Risk Management) and Tax Management Strategies.

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1. INTRODUCTION

In the globalization world, multinational companies (MNCs) keep expanding themselves to farther areas where costs are cheaper and the gap in tax rules exist. Therefore, several MNCs attempt to use transfer pricing as a tool for effective tax avoidance or tax evasion. Some large businesses, for example, Starbucks, Amazon, and Google are accused of using transfer pricing for tax avoidance activities due to low payment of corporate income tax in the United Kingdom although they report their large sum of profit in the United States (Huda et al, 2017). As a result, tax authorities worldwide pay more attention to transfer pricing during the tax audit because excessive

use of transfer pricing causes tax income loss for tax authorities and trigger them to perform transfer pricing audit to gain more corporate income tax from firms (Urquidi & Thompson, 2010; Sikka & Willmott, 2010). At the same time, Thailand's Tax authority; so-called Thai Revenue Department (TRD), tightens up their transfer pricing law by enforcing the firms in Thailand which generate the revenue exceeding 200 Million Thai Baht to submit the report disclosing transaction details with a related company, starting from 2020. It causes firms to raise their awareness of transfer pricing to protect themselves from being accused of using abusive transfer pricing penalized for tax shortfall. Therefore, understanding the potential transfer pricing risk and its impact ahead of time is necessary for all industries, especially automotive industry, as it is one of the targets for transfer pricing inspection due to its complexity of transaction within a long supply chain and has a great impact on Thai economy (Ernst and Young, 2012).

The objective of this study is to identify transfer pricing risk factors within Thailand's automotive industry and understand the severity and priority of identified transfer pricing risks to raise awareness and manage the risk response efficiently.

This study is useful for the participants of the study, the accountants in automotive companies because they can use the experts' opinions as their reference to assess their company's transfer pricing risk. Moreover, other industries with the same function as the automotive industry can use this study as a guideline to do transfer pricing assessment. This study raises awareness of some other transfer pricing risk factors that have never been seen as critical ones before. The experts' opinions and advice clarify the fact and give us a wider scope of reliable knowledge.

2. LITERATURE REVIEW

2.1 TRANSFER PRICING RISK FROM FINANCIAL TRANSACTIONS

Transfer pricing has been a long-lasting controversy among global MNCs and tax authorities. Several transfer pricing cases of renowned MNCs; Starbucks, Chevron, and Amazon, show the dispute between MNCs and tax authorities. The common issue found in these three cases is that they are suspected of financial transactions. For example, an intra-group loan or royalty from intangibles can shift the profit to cross-bordered related entities to reduce their tax bill (Sari & Hunar, 2015; Vann & Cooper, 2016; Nevius, 2017). There are certain types of risky financial transactions for transfer pricing purposes.

At the same time, the Organization of Economic Co-operation and Development (OECD) introduces the inclusive framework of Base Erosion and Profit Shifting (BEPS) to solve tax avoidance issues and ensure consistency of transfer pricing with arm's length principle together with an alignment of economic value by proposing an implementation of 15 action plans. Among BEPS 15 actions, action 4, 8, 9, and 10 are introduced as transfer pricing on financial transactions between intragroup companies (OECD, 2013).

1) Action 4 recommends a limitation of interest deductions to prevent base erosion from interest expense. MNCs may utilize the adjustment of debt amount among group companies to gain favorable tax results such as using an intragroup loan to generate excessive interest deduction or to gain tax-exempt income.

2) Action 8 focuses on intangibles relating issues from transfer pricing due to its mobility and hard valuation. It covers the contents on the adoption of a broad and clear definition of intangibles, suitable allocation of profits arisen from the intangible usage or transfer in accordance with value creation, rule development of hard-to-value intangibles.

3) Action 9 considers the contractual allocation of risks which may not correspond with executed activities. Besides, Action 9 indicates the correspondence of the level of returns by the funding entities, and the level of activities undertaken by the funding company.

4) Action 10 addresses other high-risk areas in various scopes such as the profit allocation from controlled transaction to related entities which are not commercially rational, the usage of transfer pricing approach to divert the profit from the most economically important activities of MNC, and the use of some payment which is hard to measure and may not align with value creation such as management fee and head office expense.

2.2 TRANSFER PRICING RISK ASSESSMENT

To prevent or mitigate tax risks, both oversea and Thailand's firms have focused on tax risk management because they believe that it gives high benefits of taxation strategy, tax risk mitigation, lower risk of tax audit burden and gains shareholder's confidence on improved tax internal control and tax governance. Common tax risk management framework was developed based on COSO ERM to control risks in the tax area (Rensburg, 2012).

Based on COSO ERM 2017, tax risk assessment is one of the key components of tax risk management which identifies, assesses, and reports risk-related matters. Thus, it is necessary to understand the process of tax risk assessment included in the 5 principles lying within Component 3 of COSO ERM 2017 (COSO, 2017).

1) Principle 10 Risk Identification. Firms identify risks from internal and external circumstances in all aspects which could have some impacts on the achievement of enterprise or business operation's targets and strategies. Risk factors and potential impact from risk will be addressed in this stage, too.

2) Principle 11 Assessment of Severity of Risk. Firms assess the severity of identified risk in multiple levels, such as an impact on the entity-wide level or at the business unit's objective level. The severity measurement is set based on its impact and likelihood but should be aligned with the nature, size, and complexity of a firm and its risk appetite.

3) Principle 12 Risk Prioritizing. Identified risk is prioritized based on the severity of risk compared with the firm's risk appetite. The priority of risks is the basis for selecting risk responses.

4) Principle 13 Implementation of Risk Response. Risk Response is selected depending on each identified risk from management decision by considering its effect on the business context, cost, and benefit, firm's risk appetite as well as risk priority and severity. Examples of risk responses are Accept, Avoid, Mitigate, and Share the risk.

5) Principle 14 Portfolio View Development. The last process of risk assessment is to develop a portfolio view of risk to assess an entity-wide risk and a current overview risk with the

entity's target and strategy at each level.

3. METHOD

This study follows COSO ERM 2017 component 3 to assess overall transfer pricing risks within Thailand's automotive industry. Considering the quality of the result and population integrity in recruiting six participants; four experienced accountants from four representative automotive companies and two experts in transfer pricing from Big Four companies, are chosen as the study samples. This study runs in-depth interviews to collect data and uses the Delphi technique in the data analysis by performing an in-depth interview for two rounds.

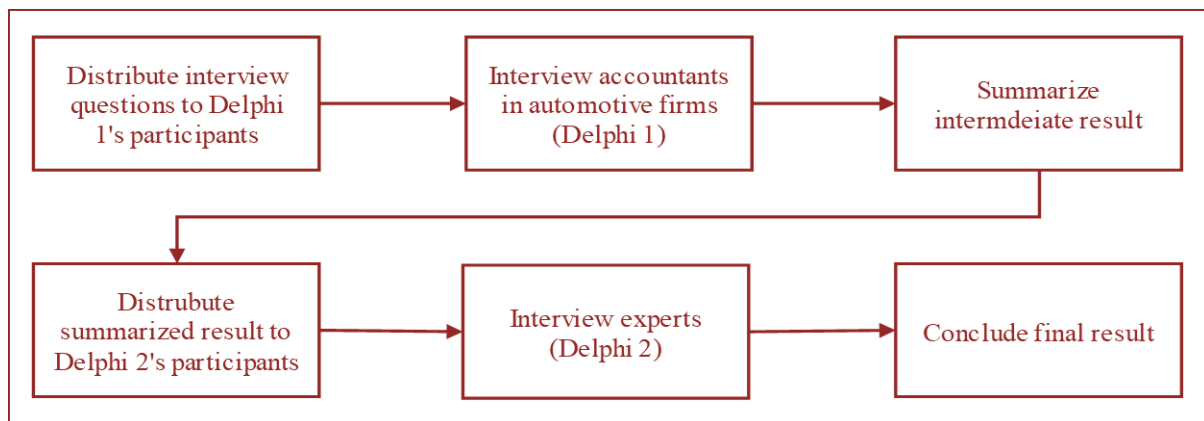


Figure 1: Research procedures

Figure 1 shows the study's overall procedure. The first round (Delphi 1) is an interview with 4 experienced accountants from automotive companies to collect the data of transfer pricing risk factors, the severity of risks, and suggested risk response method based on the transfer pricing risk assessment process in COSO ERM 2017. The predetermined questions are distributed to the participants beforehand while in-depth interviews are conducted and summarized in the following process.

1) Risk identification. Upon interview with participants in Delphi 1, information related to transfer pricing risk must be identified. Transfer pricing risk is the main risk identified in this study. So, the interview focuses on risk factors across business functions in the automotive industry which might cause transfer pricing risk and its impact on tax aspects.

2) Transfer pricing risk rating on severity. Each participant needs to assess the severity of each identified risk by rating impact and likelihood level to prioritize each transfer pricing risk and find an appropriate risk response. The rating criteria of impact are based on external auditor's materiality, using net income after tax as a qualitative benchmark (Eilifsen & Messier Jr, 2015). The rating criteria of likelihood are based on participants' experiences and opinions of how probable a taxpayer uses this kind of situation or transaction to perform transfer mispricing or to trigger tax administration in performing tax audits.

3) Prioritizing risk and Risk response. Identified transfer pricing risks, of which the impact and likelihood are assessed, are prioritized before selecting an appropriate risk response. Moreover, each participant is required to give a risk response method for transfer pricing risk to develop an

overall risk response solution.

4) Develop an overall risk matrix. The researchers gather information in steps 1 to 3 from each participant, summarize them in an overall transfer pricing risk assessment, and show in a risk matrix format.

According to the intermediate result summary in Delphi 1, such a result is distributed to the second round of interviews with expert consultants in the transfer pricing area from the Big Four companies (Delphi 2). The interview with Delphi 2 collects the experts' professional opinions on intermediate results to assess the consensus of the responses between 2 rounds of interview and improve the study's validity. Then, their opinions are added to the final result summary.

4. FINDING AND RESULT

4.1 TRANSFER PRICING RISK FACTORS IN AUTOMOTIVE INDUSTRY IN THAILAND

4.1.1 INTELLECTUAL PROPERTY

In the automotive industry, Intellectual Property (IP) is a kind of patent or know-how relating to the product or part design, manufacturing, and assembling, including trademark, to manufacture finished vehicles or parts. It sometimes involves a right to modify or develop product and part design. Generally, the transactions related to IP have two types. The first one, called outright IP acquisition, is used when the company invents the IP and plans to sell and transfer the ownership of IP to the buyer. Then, the buyer, as IP's new owner, has IP possession right to manufacture parts or vehicles based on purchased IP. The second type, called running royalty, is used when the IP owner grants the right to use the IP. Since the ownership is not transferred, the grantee needs to pay back the royalty regularly based on sales of such products. In any case, both Delphi 1 and 2 unanimously choose IP as the top priority transfer pricing transaction for TRD because of its difficulty in valuation.

The experts clarify IP valuation issues. As for outright IP, there are two prominent valuation methods; Cost Approach and Discounted Cash Flow method (DCF). In basic taxation rules, the estimation or assumption by both methods is not acceptable to be recorded as an expense in taxation. The cost approach uses the assumption of the total cost as if we make a new IP. Similarly, the DCF method uses the assumption of generated future income. This problem urges us to find some ways to prove to TRD that the assumption we use in the valuation is the closest value to reality. Several firms choose both the cost approach and DCF to see if the outcome remains at least nearly the same. If so, the assumption is proved reasonable.

While the valuation of outright IP is difficult to prove the assumption, the valuation of running royalty is much easier. The expert gives an example to clearly understand how to value royalty. "Mr. A is the owner of a shirt factory. It produces simple white shirts and sells them at 100 Thai Baht price in which the cost per piece is 95 Thai Baht. Thus, the profit per piece is 5 Thai Baht. One day, Mr. A rescues Mr. B at the beach. During that time, Mr. B is the owner of a leading brand in the garment industry. Mr. B, knowing that Mr. A is an owner of the shirt factory, wants to thank Mr. A by giving him the right to freely use the logo of his brand for the rest of his life. Then, Mr. A

puts the logo on his shirts before increasing the selling price from 100 to 500 Thai Baht, of which the cost increases from 95 to 105 Baht. The profit sharply increases from 5 to 395 Thai Baht per piece. But Mr. B suddenly dies a year later. His family asks Mr. A to pay the royalty if he continues to put the logo in the products. The problem is how to calculate the royalty. The royalty is the value between the profit Mr. A makes before putting the logo and the highest profit Mr. A makes from producing shirts with the logo within a range of 5 to 395 Thai Baht". This explanation is an easy case study. When there is a residual profit left from using IP, it becomes a cause of paying royalty back to the IP owner. Even though most of Thailand's automotive companies usually pay royalty 2-6 percent, there is no guarantee that it is an appropriate range of royalty fee setting.

4.1.2 PROFIT ALLOCATION IN ACCORDANCE WITH RISK BEARING FUNCTION & CAPITAL

In the business with a long supply chain in the automotive industry, most parent companies are located abroad. Therefore, there triggers the distrust in taxpayer and tax authority whether the companies in Thailand transfer their profit to the parent company or group companies overseas. At this point, TRD uses a profit range which should be in accordance with risk-bearing function and capital as a principle to examine how much the appropriate bottom line in a company is.

Delphi 1 and 2 share the same opinion that the more function of work there is, the more risk to bear and the higher profit than other companies with less function of work. For example, a trading company, only aiming for sourcing and delivering goods to distribution centers to customers in the domestic or international market, has a very low risk as it does not need to stock up inventories. In terms of manufacturing companies, they must invest in a production plant and bear risk from unsold assembled products. So, the profit should be higher to compensate for these risks. High risks should come up with a high rate in return. The expert gives the opinion in two different aspects depending on business type and structure which are Completely Knock-Down (CKD) and Completely Built-Up (CBU). CBU imports finished vehicles and sell to the dealer in Thailand so the risk caused by the limited function of work is at a low rate. On the contrary, CKD involved in importing parts for assembly in Thailand must deal with high-investment. Its work function becomes riskier. CBU acts as a distributor with limited processes of work and low risk while CKD bears higher risk from huge investment together with various work processes. CKD theoretically has a higher profit than CBU. Hence, a lack of awareness in maintaining a bottom line in accordance with the risk-bearing function and capital is one of the transfer pricing risk factors which have an impact on the tax bill. It is necessary to consider the risk of every function in the domestic and international supply chain as a whole because TRD must prove the final profit in selling vehicles go to which company and whether it is in relation to risk-bearing function and capital. Therefore, automotive companies should highlight the benchmark among third party companies in the same industry with similar work functions and risk to check if the company's profit in the group is at the same level as others in the same industry.

4.1.3 HIGH-RISK TRANSACTIONS RELATED TO SERVICE

According to Delphi 1, there found many high-risk transactions related to service such as management service, consultation service, and research & development service among intra-group

companies. TRD may raise some questions about service fee calculated from man-hour rate to find out whether it is reasonable or prove whether the service is truly rendered to the client by asking for evidence such as pricing calculations, reports, or deliverables. However, Delphi 1 participants do not show their worries because they strongly believe that no issues occur once supporting documents are well-prepared.

Contrary to Delphi 1's opinion, the experts show concerns on these transactions that there are three main transfer pricing issues that companies must be aware of. First, transfer pricing risk may result from overlapping services. Some companies hire several kinds of services such as human resources, marketing, and management service. These companies need to ensure that the scope of such service received or rendered is not overlapped with one another. TRD may suspect the firm of using overlapped service as a transaction to shift the profit. Second, requests of service from related parties in spite of enough manpower may cause transfer pricing risk. TRD may deem the service as a transaction to shift the profit to a related entity when the firm hires a related entity to perform, even though the firm can perform the service by itself. Third, proof of service fee calculation is not an easy task as expected. Service fee is quite subjective compared with selling goods. Companies must calculate all related costs into an average man-hour rate of employees at each level because of the difference in personnel expertise and cost. TRD would not approve this method if executives and employees render the same service but gain the same amount of income despite the difference in salary and expertise. Also, the appropriate time spent in each task must be together calculated because it greatly affects the amount of service fee. Supposing that the detailed service by executives and general employees is the same but the executives are estimated to complete within 10 hours while the general employees take only 2 hours, the service fee does not match the rendered service. Historical data is the best proof of setting the pricing policy and it must be used to back up calculations.

4.1.4 INTERESTS FROM INTRA-GROUP LOAN

Both accountants and experts share the same opinion that transfer pricing can be easily done through a loan or debt financing between intra-group companies as it is a common case in the automotive industry due to high investment in new model production. However, this method is not favorable because the transferable profit is low compared with IP or service transactions. Moreover, the market price of interest can be easily checked because it refers to commercial bank interest rates.

4.1.5 ARM'S LENGTH PRICE CALCULATION AND PRICING POLICY

To prove arm's length price, the appropriate calculation method and market benchmarking within the automotive industry must be selected to set the company's pricing policy and business plan aiming to maintain an appropriate profit level. Delphi 1 points out that TRD might challenge the arm's length price calculation and pricing policy. TRD would disagree with the selected calculation method or comment that the benchmarking companies are not suitable in function and risk, the population for benchmarking is not enough, the pricing policy is not related to the company's latest condition. Inappropriate use of arm's length price calculation and wrong pricing policy causes a difference in profit at the bottom line, which may take the profit out of profit range

from the benchmark and cause transfer pricing risk. However, Delphi 1 has some concerns about the appropriateness of selecting an arm's length price calculation. They comment that some TRD lack knowledge in complicated transactions and cost structure in the automotive industry so there is a gap in counterchallenging.

Delphi 2 shares the same opinion that the arm's length price calculation can be risky. Apart from selecting the calculation method and benchmarking, pricing policy review is one of the most crucial tasks. Companies should regularly update their pricing policy because the current pricing policy may be challenged in the next three or five years afterward. At that point in time, TRD may challenge by asking for more information or historical data with a higher rate of accuracy than what companies have when setting policy. This concept is called a Contemporaneous concept. Hence, a regular update of pricing policy is necessary for mitigating risk. In addition, the experts in the costing of the automotive industry believe that firms offer a more reliable calculation method and successfully negotiate TRD.

4.2 TRANSFER PRICING RISK PRIORITIZATION

The severity of identified 5 potential transfer pricing risk factors is measured by rating their impact and likelihood. Figure 2 shows the risk matrix prioritizing the severity of each risk factor responded by Delphi 1 and 2.



Figure 2: Risk matrix created from the responses of Delphi 1 and Delphi 2.

From the responses given by Delphi 1 and 2, both choose intellectual property as the top priority of transfer pricing risk and the highest severity among five transfer pricing risks. The impact is rated high by every participant because the IP value is incredibly high. In addition, hard-to-valuation makes less possibility to win the negotiation against TRD. In the case of running

royalty, TRD may challenge five years back which cause a significant impact on the financial statement. As for likelihood, both participants and experts affirm that TRD would challenge this transaction because IP is valued at least around 10 billion Thai Baht.

Second, both Delphi 1 and 2 rate profit allocation in accordance with risk-bearing & capital at a high level. The average impact is in the medium because the risk can be controlled by maintaining the profit within the benchmarked profit range. Still, there exists the other remaining impact. Once TRD assesses the profit too low, it implies that the revenue from selling vehicles might increase after assessment. So, the excise and custom tax paid at a higher selling price must be paid, too. The likelihood is rated as high unanimously. They believe that TRD accesses all firms' financial information through the submitted audited report and uses this information to benchmark profit with all companies in the same industry. It increases the higher chance of triggering TRD for transfer pricing audits.

As for the high-risk transaction related to service which comes to the third, Delphi 1 and 2 have different viewpoints. The opinion is also different even within participants in Delphi 1 themselves. In terms of impacts, some accountants agree that the amount of service is not high, compared with IP or with profit adjustment related to risk-bearing & capital. Even if the company is assessed by TRD in this aspect, they show official supporting documents such as related reports, deliverables, invoices, and quotations. As for likelihood, these kinds of services are common so it may not be the top priority for transfer pricing audit. In contrast, other accountants and Delphi 2 agree that the impact is rated medium because of the same reason but the likelihood is deemed high. Transaction related to service is closely focused by TRD because the suitable service fee is difficult to prove and supporting documents such as deliverables might not be able to prove the service's existence. In addition, management service has never been ignored because several companies use the terms of management service in both existing and non-existing service but there is neither definition nor exact details of work in such a service. This causes TRD to thoroughly investigate these transactions. Hence, some accountants in Delphi 1 and the experts in Delphi 2 score the impact as medium and likelihood as high for high-risk transactions related to service.

As for arm's length price calculation and pricing policy which are the fourth, Delphi 1's opinion is unanimous. Both impact and likelihood are rated as low risk. They believe that TRD is not experienced enough in transfer pricing and has an inferior understanding of complex cost structures and technical skills. Hence, the company can negotiate this problem with TRD. Therefore, the impact is estimated unlikely while the likelihood is rated low because of authorities' lack of experience. The experts partially agree with Delphi 1 in terms of impact. On the contrary to Delphi 1, both experts score likelihood high because Thailand's automotive industry has been on the top priority list of TRD in challenging transfer pricing for so long.

Lastly, the interest, the least risk among the other five. Both Delphi 1 and 2 rate the interest as low impact and low likelihood because the interest income or expense is usually lower compared with others. The impact is likely to be very small and has a low chance to draw attention from TRD.

4.3 TRANSFER PRICING RISK MITIGATION METHOD

As suggested by Delphi 1, the company's pricing policy is the top priority in risk mitigation.

The firms should focus on how to create a suitable pricing policy so that the profit at the bottom line falls within the market's average profit range. Yet, Delphi 2 believes such a method is not suitable since it merely uses a favorable pricing policy to explain the firm's expected profit without considering the real economic value of each transaction. Thus, the experts recommend a more sustainable way to mitigate transfer pricing risk. The firms must clearly understand their business in order to choose the most suitable pricing policy and appropriate margin from benchmarking which matches well with each of their business beforehand and then embed into a business plan in order to set the appropriate profit amount. Besides, the Advance Pricing Agreement (APA) is another risk mitigation method. It is an agreement between taxpayer and tax authority in two countries on an appropriate transfer pricing methodology of one or a set of transactions in advance. This method helps any automotive companies bargain and fix profit with the Thai and Overseas Revenue Department in advance for around five years. During such a period, the Revenue Department authorities do not investigate the committed transaction whenever it falls within the agreed profit range. This method is used once there found any job functions or operation changes that drastically move the profit from one country to another.

5. CONCLUSION

This study applies COSO ERM 2017 in assessing transfer pricing risks in the automotive industry. It shows that accountants in the automotive industry are experienced in transfer pricing because they can identify 5 potential key transfer pricing risk factors in which the experts totally agree. They match both OECD's BEPS actions and transfer pricing scheme in worldwide transfer pricing cases. Notwithstanding, accountants in automotive companies might not be aware of some transfer pricing risk factors even though they are the top priority for TRD such as high-risk transactions related to service and arm's length price calculation and pricing policy. Besides, the participants might not aware enough of the risk mitigation method of setting the best pricing policy to maintain the profit within the profit range. To efficiently manage the risk, understanding business is the most important process before selecting a pricing policy. Thus, the best pricing policy should be selected after the business, including the risk-bearing function, is analyzed. Apart from the mentioned methods, APA is another effective risk mitigation method suggested by experts, specifically used to negotiate the profit level with the revenue department in advance.

6. AVAILABILITY OF DATA AND MATERIAL

Data can be made available by contacting the corresponding author.

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