

## **ABSTRACT**

### **The Impact of Corporate Governance on the Choice of Transfer Pricing Methods in China**

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Recent scandals involving related party transactions (RPTs) have attracted researchers' and governments' attention. Because imperfections exist in the legislation of RPTs, business groups might abuse transfer pricing of such transactions for certain purposes. These purposes include earnings management of listed companies that seek to attract investors and profit shifting from subsidiaries to parent companies. This study investigates the impact of corporate governance on the choice of transfer pricing methods in China.

I classify transfer pricing methods into two major groups (i.e., market-based and cost-based methods). I hypothesize that companies with weak corporate governance are more likely to use cost-based pricing methods, which are regarded as subjective and more easily manipulated. According to previous studies on corporate governance, a smaller board size, CEO-Chairman duality (i.e. the CEO and the Chairman of the company are the same person), and a lower percentage of independent directors on the board are indicators of weak corporate governance. Using data collected from annual reports of Chinese listed firms in the Shanghai and Shenzhen Stock Markets from 2003 to 2005, I find that government-controlled companies are more likely to use market-based methods than others. It is consistent with the hypothesis that ownership has an impact on the choice of transfer pricing methods. The results also show that when the chairman of the board and the CEO of the company is the same person, companies are more likely to use cost-based methods. However, inconsistent with my hypothesis, the results indicate that firms with small boards are more likely to choose cost-based methods than firms with large boards. This study extends prior research on transfer pricing by focusing on the impact of corporate governance. Furthermore, this study suggests that regulators might limit transfer pricing manipulations by stipulating a firm's corporate governance structure. This research also draws both regulators' and investors' attention to the impact of corporate governance on transfer pricing methods.

*Key words:* Transfer Pricing Methods; Corporate Governance; Related Party Transactions