

INTERNATIONAL TRANSFER PRICING

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ABSTRACT

The goals of transfer pricing are to assign a monetary value to a transfer and to minimize the taxes paid by a company as whole. However, because a single company can now have operations literally around the world, transfer pricing has become a very complicated, costly, and lucrative business strategy. The purpose of this paper is to explore the effects of transfer pricing on both the company, its divisions, as well as the countries involved in the transaction. We will also discuss the consequences of transfer

pricing on the bottom line of a company and a country, the tax planning opportunities, the effects on company personnel, and the ethical implications of this practice.

INTRODUCTION

Transfer pricing is the price placed on a product or service by one division of a company in order for another division of the same company to acquire that product or service. Without this assignment of value, the division creating the product would not receive any credit for the product it created (Noreen, 2011). The transfer pricing data are very important for department managers who take these results into consideration of their division's costs and profitability. Ultimately, though, the transfer pricing transaction itself has no monetary effect on a firm's reported profit overall as a whole, if the entire transaction takes place within the company (Noreen, 2011), provided only one taxing jurisdiction is involved. Nevertheless, transfer pricing is extremely important to a company, its divisions, and the countries involved in a number of ways. This paper will provide an analysis of the effects of transfer pricing on a firm's bottom line, tax planning, personnel, and the ethical implications.

REVIEW OF LITERATURE

Executives can divide a company into various divisions that can specialize in a particular component of a final product or develop a completely different product line that adds to the company's product repertoire. Globalization has created a considerable opportunity for businesses to utilize raw materials, labor, manufacturing capacity, and intellectual property and prowess that may not be available in the firm's home country. This has created multinational enterprises (MNEs) that have divisions

all over the world. Transfer pricing allows specialization and globalization to take place profitably.

MNEs have to justify their transfer pricing and fee structures to governmental and taxing authorities. As a general rule, the transfer price should be comparable to the price commanded by an outside seller. This standard is called the arm's length standard. However, there is a range from 50%-200% of the comparable outsider's price that is considered acceptable in most cases (Faille, 2012).

Therefore, when tax auditors review these transfer prices, they are ensuring that not only has the correct tax been paid, but also that the correct transfer price has been assigned to the transfer transaction in the first place (Radolovic, 2010). If the transfer price is inappropriately low, then appropriate taxes have not been paid to the government by the MNE. Audits that reveal deviations from the appropriate transfer price can result not only in an unexpected increase in taxes, but also huge fines (Faille, 2012). These fines can range from 20-40% of the outstanding tax balance (Wikipedia, 2012). Thus, it is imperative for the MNE to use and accurately document the transfer price scheme using established acceptable practices to assign the appropriate transfer price to the product and ultimately determine the correct amount of taxes to be paid to the government (Radolovic, 2010).

Taxing authorities assume that the competitive market is the best judge for pricing a product. Pondent (2012) and Jennifer (2012) indicated that the United States (U. S.) and the Organization for Economic Cooperation and Development (OECD) recommend that the transfer price be compared to the price the product would sell for on the open market by an independent company whose goal is the make the most profit possible on each sale of an identical item under identical terms and conditions, where neither party is under any compulsion to act (Pondent, 2012; Jennifer, 2012).

This is the arm's length standard used to ensure that transfer prices are fairly set. As noted, there are many assumptions made in the arm's length standard on many nonreproducible

conditions that may not occur within an MNE. This complicates the implementation of the arm's length standard. There are rarely identical items between different companies. The transfer price may differ due to differences in the amount and quality of materials used, variation in the services that are provided, or just differences in the locale and timing that the product is made or the service is provided (Styron, 2007).

Eden says that "most tax authorities do recognize that an arm's length price may not be a particular price point but rather a range of acceptable prices" (Eden, 2007). "Vast differences among points in the range may indicate lack of reliability of data. The data becomes more reliable if it is gathered over the course of multiple years" (Eden, 2007). Radolovic (2010) recommends that European MNEs use the Amadeus databank developed by Bureau van Dijk to establish its transfer pricing. Bureau van Dijk has also developed a more extensive databank called Orbis, which publishes the prices of products and services of over 100 million companies and MNEs around the world (Bureau van Dijk, 2012).

The databank was created to "identify comparable companies" and products and "prepare country-specific documentation for most countries," while ensuring compliance (Bureau van Dijk, 2012). It is designed to help MNEs assign the correct transfer price for their transaction and pay the correct amount of tax.

Various techniques exist for firms to follow for assigning prices for transfer pricing purposes. Commonly used methods include comparable controlled prices, cost-plus, resale price, profit split, and net profit methods (Kouser, 2012; Radolovic, 2010). The comparable controlled price method is a good means for examining prices among firms. It involves having a comparison of identical products and services from an independent company to serve as the "control". The downside of this technique is that an unbiased comparable substance is not always available (Radolovic, 2010).

The cost plus method involves providing the product or service to another entity at the actual price plus a gross margin.

The goal of this method is to recognize a profit (Radolovic, 2010). The resale method involves assigning a price to a product to what a company would sell it for to an independent buyer at a standard listing price, minus any discount that may be offered. This pricing technique is used where the seller does not really add much more to the product (Radolovic, 2010).

Profitability based methods rely on examining industry standards and on microeconomic analysis (Noreen, 2011). They are used when “it is difficult to identify a specific transaction” (Radolovic, 2010). In the profit split method, the profit made in the transaction by both the seller and the buyer is compared to the profit that would be made in the arm’s length standard by each independent company (Radolovic, 2010). The net profit method compares the total profit made by the MNE in the transaction to the profit made in the arm’s length standard by each independent company (Radolovic, 2010).

Transfer pricing is more than just a technical issue for taxing authorities. Several features of the contemporary tax landscape combine to make transfer pricing a high priority for both national taxing authorities and international organizations such as the OECD (Rectenwald, 2012). Governments view the taxes from transfer pricing as a legitimate source of income. Many tax authorities and governments recognize that “transfer pricing can be manipulated to avoid paying taxes” (Eden, 2001). Radolovic (2010) opines that, “a substantial increase in tax audits, especially those focused on transfer prices, should only be expected by MNEs.”

Guidelines for transfer pricing have been set by large organizations such as the OECD and the U. S. Internal Revenue Service. However, the OECD has no regulatory responsibility, and no regulatory instruments within its control. Thus, the OECD rules are merely guidelines without meaningful legal force (Wolfe, 2011). Even the U. S. Internal Revenue Service takes a relatively hands-off approach to transfer pricing. According to Wolfe (2001),

U.S. rules specifically provide that a taxpayer's intent to avoid or evade tax is not a prerequisite to adjustment by the Internal Revenue Service. The U.S. rules give no priority to any particular method of testing prices, requiring instead explicit analysis to determine the best method. U.S. comparability standards limit the use of adjustments for business strategies in testing prices to clearly defined market share strategies, but permit limited consideration of location savings. OECD rules permit consideration of business strategies in determining if results or transactions are comparable. Such strategies include market penetration, expansion of market share, and cost or location savings. Factors that should be considered when determining comparability are the nature of the property or services between the parties, functional analysis of the transactions, comparison of contractual firms, and a comparison of economic conditions (Wolfe, 2011).

THE EFFECTS OF TRANSFER PRICING ON THE BOTTOM LINE

As mentioned earlier, transfer pricing allows specialization and globalization to take place. Transfer pricing permits one division to use the products or services of another division, while recording a "revenue" for the transferring division and a "cost" for the recipient division. Transfer pricing allows managers to have a clearer understanding of the total costs of production, the acquisition of products, and the ability or inability to generate profits.

If a division were just given a product without any accountability, even by another division of the same company, that gifting would result in the misperception that the transferring

division was losing money, and the recipient division was more profitable than would actually be the case. Moreover, the product produced by the transferring division is not devoid of worth and would command its own price on the open market.

Likewise, if the transferring division did not exist, the recipient division would have to pay for the items from an independent source, likely at a higher price. It follows that transfer pricing can result in significant cost reduction for both divisions. The transferring division does not have to consider variable selling costs. The recipient division does not have to consider the labor costs of finding the needed products, or shipping costs if the receiving division is located in the same facility. Therefore, most companies will use intercompany products and services whenever capacity will allow even the partial fulfillment of an order or request because transfer pricing can result in huge savings for the company as a whole (Noreen, 2011).

Usually less developed countries can offer companies cheaper materials and labor inputs to permit the production of cheaper products. Many times these less developed countries rely on these businesses to provide jobs for their citizens. As if the cheap materials and labor were not enough of a motivating factor, the governments in these less developed countries will often further entice foreign-based businesses to come, stay, and expand in their countries with lower corporate tax and transfer price tax rates. According to some scholars, this creates what is called “the race to the bottom” between countries as they compete for the business of MNEs (Raimondoes-Moller, 2002). However, other scholars disagree with this assessment, and take the position that allowing resources to be allocated to their most efficient location is beneficial, overall, and results in a race to the top (Larsson, 2001; Marber, 1998).

As alluded to earlier, when two divisions of the same company are in different countries, taxes are imposed on the transfer pricing transaction. By strategically choosing a division, the subsequent strategic transfer pricing allows the company to

take advantage of different tax rates, tax cuts, and breaks that can be afforded by taxing authorities and governments. These tax breaks can reduce the total tax burden for the company as a whole and yield substantial savings for the company (Rectenwald, 2012). As companies move products and services from one division to another in this new age of MNEs and transfer pricing, companies are effectively shifting profits from one division to another and moving capital throughout the world (Raimondoes-Moller, 2002). As a result, profit margins are increased for these MNEs (Rectenwald, 2012).

MNEs, specialization, and globalization can create a quadruple positive effect for the foreign country: 1) job creation for the citizens, 2) income tax revenue from its now employed citizens, 3) corporate income tax revenue from the MNE, and 4) transfer price tax revenue from the MNE. However, this undermines the home country's efforts to support its government in the four exact opposite ways: 1) loss of jobs for its citizens, 2) loss of income tax revenue, 3) loss of corporate tax revenue from the MNE staying in its home country, and 4) loss of transfer price tax revenue.

Strategic transfer pricing thus creates a global taxing battle: the tax authorities of the foreign country against the tax authorities of the home country. Usually one player will come up short. Generally it is the home country, as profits are shifted to the country with lower taxes (usually the foreign country) while the tax revenue of the home country erodes (Rectenwald, 2012).

In today's global recession and economic decline, every country wants its share of the global tax dollars to support its government (Radolovic, 2010). As mentioned above, less developed countries will entice MNEs to bring their divisions to these countries with lower corporate and transfer tax rates. However, even as the recession hits these countries, these governments are increasing their efforts to extract more tax revenue from these perceived "wealthy" MNEs by means of transfer price tax audits (Radolovic, 2010).

Foreign countries also realize that MNEs have “used strategic transfer pricing methods to shift profits from the home country to the foreign country” on the books (Raimondoes-Moller, 2002). These countries increasingly believe that if profits are recognized in their country, then appropriate taxes should be paid, and thus are increasing their auditing efforts (Radolovic, 2010). Furthermore, many foreign countries base their transfer pricing efforts on boom years and thus want to charge the MNEs more in taxes (Radolovic, 2010).

MNEs need to make adjustments in their transfer pricing documentation to accurately reflect the lack of profitability or bust-recession-time to avoid paying unnecessary transfer price taxes (Radolovic, 2010). Radolovic (2010) encouraged MNEs to invest in or consult with a tax firm that has corporate databanks, like Amadeus and Orbis, which have accurate financial information to establish accurate transfer pricing and transfer price tax fee structure at the acceptable arm’s length standard. Proper and well thought-out documentation will ensure that MNEs will continue to take advantage of low transfer price taxes that foreign countries legally afford them to reduce their overall tax burden and increase profit margins by profit shifting and capital mobility.

TAX PLANNING OPPORTUNITIES

The parent company of an MNE can strategically use the intercompany sale to a foreign subsidiary as an opportunity to reduce the overall tax liability of the company (Styron, 2007). The goal of the parent company is to minimize the taxes paid by the entire MNE as a whole globally. A company can “adjust” the price of a product made by one division favorably or negatively (Kocic, 2012). If the transfer price is set low in the low tax jurisdiction, more profit will be assigned to that low-tax rate jurisdiction (Dreiser, 2012). MNEs take advantage of such tax laws because the OECD says that MNEs should not be double taxed in an effort to encourage globalization and free trade (Bartelsman, 2000).

Bartelsman and Beetsma (2000) discussed in their paper that globalization, outsourcing, and transfer pricing occur more often when the corporate tax rate in a country is high. They noted that when corporate tax rates increase even by just one percent, the corporate tax revenue decreased by three percent due to transfer pricing (Bartelsman, 2000).

They go on to say that profit shifting will continue to occur as the production of intermediate goods increases in countries with lower corporate tax rates (Bartelsman, 2000). The parent company then acquires these intermediate parts through transfer pricing. It is willing to pay the income tax, which is also lower in the foreign country.

These lower corporate tax rates ultimately lower the MNE's total global tax bill. A real life corporate example of this business diaspora involves the Puerto Rican government. Puerto Rico has a "possession tax credit, the income generated in Puerto Rico is in effect completely exempt from U. S. corporate taxation, while the taxation by Puerto Rico is virtually negligible" (Bartelsman, 2010).

Therefore, many U. S. based MNEs will create divisions and manufacturing plants in Puerto Rico. They design acceptable transfer pricing schemes and willingly accept the lower Puerto Rican income tax in an effort to decrease their total global tax bill. Bartelsman's (2010) research suggests that transfer pricing is a natural result of high corporate income taxes. Therefore, transfer pricing will continue at its present rate, if not increase, if corporate income tax rates in developed countries like the U. S. and Europe continue at their current rate or increase.

Bartelsman does suggest enforcing transfer pricing rules at the very least to reduce profit shifting and to capture at the very least the revenue from tax rate differentials (Bartelsman, 2010).

Another solution would be to capture more tax revenue from MNEs, which would require the cooperation of multiple nations and would have a potentially huge payoff yield. Developed countries could coerce and/or entice less developed nations to claim less in taxes to allow the developed country to claim more of

the taxation (since international law says an MNE cannot be double taxed) and then give the developed country some of the received tax revenue. Since developed countries also tend to have higher tax rates, this could theoretically result in more tax revenue generated globally as a whole. In fact, the international tax laws could be changed so that instead of the product being taxed by the government of origin, the tax could be based on the higher tax rate of the two governments involved in the transaction. This would actually balance the loss of corporate tax income in the developed nations due to the MNE avoiding their home country's tax. However, this would require extreme cooperation, trust, and collaboration among nations that may have competing interests.

THE EFFECT ON PERSONNEL

Employees are directly affected in multiple ways by the transfer pricing policy a company chooses. Chief among these are morale, compensation, and productivity. In most companies, manager compensation is determined by the performance of the company and its division. McGee (2010) states, "If their unit is profitable, their bonus should reflect that fact. Likewise, if their unit is not profitable, their bonus should reflect that lack of profitability." Examine the following example:

"A company operating in both the U.S. and in Korea may transfer goods between the two units. If the unit in Korea manufactures golf clubs and ships them to the U.S. division to be sold, then they must do so at a particular price. If the price charged the U.S. division is lower than the actual cost of the golf clubs to the Korean division, then this may cause the Korean division to appear to be underperforming or performing poorly and the U.S. division may appear to be performing very well. Even though this could reduce the taxes paid to the Korean government, it could also definitely impact

the performance evaluations of the managers in the respective countries” (Jeffers, 2008).

This can also lower the morale of the organization, since compensation will be decreased, although management has no control over the actions taken by headquarters or government. Mehadfi (2000) also argues that this pricing structure can lead to additional issues. He notes, “When a transfer pricing regime is imposed from headquarters it takes away their decision making ability and autonomy.” This could greatly impact the trust and cohesion within an organization as well. Managers aware of these actions could experience a substantial loss of motivation.

All these negative factors can lead to a reduction in productivity and morale. With numerous factors outside the control of the managers, it becomes more difficult to encourage productivity and morale, as managers may feel that it is out of their control whether the company is productive or not.

ETHICAL ISSUES

While tax evasion is illegal, tax avoidance is perfectly legal. However, tax avoidance can be an ethical issue. Hansen argues,

Tax avoidance must be distinguished from tax evasion. Tax evasion would clearly be viewed as unethical. It is also illegal. Tax evasion entails deception and concealment. On the other hand, the taxpayer practicing tax avoidance is merely behaving in a way which hopefully will reduce tax liability (Hansen, 1992).

The use of transfer pricing as a tax avoidance strategy causes great debate. Consider the following:

Suppose a MNE with several divisions in the U.S. is not doing well this year and projections show significant losses. At the same time, projections of

the European operations show good profitability. By increasing the cost of key products that are transferred to Europe from the U.S. division, it is possible to increase the revenues and profits in the U.S. division. Hence, by decreasing profits in France, then the MNE can avoid paying taxes in France. In addition, it may serve as an easy way to transfer out capital from countries where there are restrictions or it may otherwise be very difficult. Furthermore, by utilizing losses on other U.S. operations to offset the corresponding increase in domestic profits, the MNE can avoid paying taxes in the U.S. as well. The net effect is an increase in cash inflow for the U.S. division (Jeffers, 2008).

This example shows how easy it is for a company to avoid paying taxes, which could be viewed as ethically questionable, assuming the government in question is morally entitled to the taxes it imposes. Over the last 500 years, some theologians and philosophers have argued that tax evasion is not always unethical, especially in cases where the government is an evil regime, where it engages in human rights abuses, where it engages in unjust wars, where tax rates are too high, or where the tax funds are wasted or wind up in the pockets of corrupt politicians or their friends (Crowe, 1944; McGee, 2012).

The second ethical issue in transfer pricing revolves around the role of the tax preparer. Jeffers (2008) gives an example:

Tax practitioners are faced with the challenging task of applying existing tax law to the factual situation of a particular entity for purposes of complying with requirements under the law. The solution(s) which flow from this process often are not clear and concise. When there is a lack of specific authority, or the law allows a choice between two or more alternatives, the tax practitioner will select the

approach or alternative which minimizes the tax liability of the entity (Jeffers, 2008).

Radebaugh (2006) sums up this concept by saying, “Tax practitioners and corporate accountants who do not minimize their client’s or employer’s taxes are thus acting unethically, because they are breaching their contractual or fiduciary duty and because they are acting inefficiently.” This perspective justifies why these actions are used so frequently. Corporate accountants are performing their job assignment based on the legal tax rules set by the country, even though it may appear to unfairly mitigate tax exposure for the MNE.

Mehafdi (2000) argues that transfer pricing “can be detrimental to the interests of host countries. In transfer pricing situations, the victim of the harm could be the transferor, the transferee, the company as a whole, or an external party.” As transfer pricing may make natural resources more available to a large MNE, depletion of natural resources may occur. An MNE may also take advantage of less rigorous environmental standards in the host country, leading to environmental damage. Mehafdi (2000) also argues that transfer pricing may result in loss of tax income and increased poverty, although this appears to run counter to available data.

Another ethical issue stems from the issue of comparability in setting the transfer price. Data represented in the arm’s length standard are not always accurate or applicable. There is such an assortment of goods that truly are different and cannot be reasonably compared. A seemingly minor difference in a product could lead to significant open market price differences. In some cases there really is no other comparable product. These situations leave the MNE with less guidance to assign a transfer price. If the taxing government differs in the opinion of the transfer price, who is to say who is right and who is wrong? Who really is being greedy here?

CONCLUDING COMMENTS

A transfer price is the price one division of an MNE “pays” for the products and services of another division of the same MNE. That “price” is just a value assigned to the transaction to ultimately assess the profitability of a division. However, the taxes placed on that transaction by a country are a real exchange of money outside of the company, affecting the entire MNE’s global tax bill and ultimately its profit margins and the bottom line.

Therefore, strategic transfer pricing can be an integral procedure in the company’s tax planning. Transfer pricing also affects individuals in the company. A division manager can be viewed as a competent and capable leader of a profitable division worthy of keeping. However, quite the opposite impression of the division manager can be formed, if the transfer pricing structure is not favorable for the division and the manager may lose his position. This can be especially disheartening if the manager feels he has no control over the assigned transfer price.

Companies wisely try to minimize taxes paid by the tax laws set in place by the country in which they are located. Unfortunately, many countries rely on taxes to support their nation. Therefore, legal tax avoidance is sometimes construed as illegal tax evasion by governments and their citizens.

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