Learning Objectives

- Explain the benefits and costs of decentralisation
- Explain the nature of, and rationale for, transfer prices and four criteria by which to evaluate transfer-pricing methods
- Calculate transfer prices using market-based, cost-based and hybrid methods
- Evaluate market-based transfer pricing
- Evaluate cost-based transfer pricing
- Evaluate hybrid transfer pricing
- Apply a general guideline for determining a minimum transfer price
- Describe the impact of income tax factors on multinational transfer pricing
- Relate the transfer price issues to the development and operation of a good management control system.
**Key terms**
- Absorption costing
- Arbitration
- Arms length principle
- Control
- Cost-based transfer prices
- Costly-to-price
- Marginal costing
- Market price
- Negotiation
- Optional use
- Price adjustment
- Price mechanism
- Pricing corporate services
- Service level agreement
- Source
- Transaction value
- Transfer Pricing
- Transfer pricing methods
- Two-step pricing
- Valuation method
- Variable costing

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**Organisation structure and decentralisation**

- Decentralisation is the freedom for managers at lower levels of the organisation to make decisions.
- Autonomy is the degree of freedom to make decisions. The greater the freedom, the greater the autonomy.

Issues; Reasons for; Consequences; Goal Congruence etc. have been discussed in other topics (e.g. Topic 3) and other units (e.g. ACT202 (CMA202))

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**Organisation structure and decentralisation - web links**

- Centralisation v Decentralisation' advantages and disadvantages of each can be found at: [http://www.tutor2u.net/business/people/org_centralisation_decentralisation.asp](http://www.tutor2u.net/business/people/org_centralisation_decentralisation.asp)
Is transfer pricing an important issue?

Transfer Pricing

- Transfer Pricing is used when products or services are exchanged between quasi-independent segments of an organisation
- Transfer pricing transactions normally occur between profit or investment centres

Transfer Pricing

- Mechanism for distributing revenue generated when a product/service is sold outside the organisation
- Shares revenue from product development through manufacturing and marketing
- Transfer pricing is not an accounting tool
  - It is a behavioural tool that motivates managers of profit centres to make the right decisions
- Transfer price
  - Is the internal value assigned a product or service that one division provides to another.
• TRANSFER PRICING AS A TAXATION ISSUE IS OUTSIDE THE SCOPE OF THIS UNIT (SEE TAX305)
• The influence of taxation
  • Transfer pricing is used by many companies to transfer profits between business units in different countries
  • This moves profits between different tax jurisdictions
  • International tax considerations will influence the transfer prices that are used for domestic purposes
  • BUT WILL NOT BE CONSIDERED IN THIS UNIT
• What will be discussed is the fact that the outcome of taxation issues often affects the “opportunity costs” associated with transfer pricing decisions and performance evaluation.

The objective of transfer pricing is to transmit financial data between departments or divisions of a company
• Transfer pricing systems are normally used in decentralised operations to determine whether organisational objectives are being achieved in each division

• Provide each segment with relevant information to determine optimum trade-off between company costs and revenues
• Induce goal congruent decisions
• Measure economic performance of segments (profit centres)
Objectives of Transfer Pricing

- A transfer pricing system should satisfy the following criteria:
  - Provide for accurate performance evaluation
  - Foster goal congruence
  - Preserve divisional autonomy

Benefits of Transfer Pricing

- Divisions can be evaluated as profit or investment centres.
- Divisions are forced to control costs and operate competitively.
- If divisions are permitted to buy component parts wherever they can find the best price (either internally or externally), transfer pricing will allow a company to optimise its profits.

Transfer Pricing: General Concerns

- Given the objectives of transfer pricing some of the major issues to be addressed are:
  - Impact on performance measures
  - Impact on firm-wide profits
  - Impact on autonomy
Transfer Pricing: Issues Addressed

- Sourcing decision
  - Should the company produce the goods/services or purchase from outside provider?
- Transfer price decision
  - If produced inside, what price should be used?
  - Who/what sets the transfer price?

Transfer Pricing: Fundamental Principle

- Transfer price should be similar to the price that would be charged if the product were sold
  - to outside customers
  - or purchased from outside vendors
- I.e. The MARKET PRICE APPROACH

Transfer Pricing: Methods

- Transfer price refers to the value placed on the transfer of goods/services where at least one of the parties to the transaction is a profit centre
  - Excludes cost allocation processes normally associated with cost accounting
  - Because such methods exclude profit elements
Transfer Pricing: Methods

- Market Based Transfer prices
- Cost Based transfer prices
  - The cost basis/standard cost
  - The profit mark-up
- Hybrid Transfer prices
  - Upstream fixed costs and profits
  - Agreement between business units
  - Two-step pricing
  - Profit sharing
  - Two sets of prices
**Transfer Pricing: Ideal Conditions**

- Competent people
- Good atmosphere/corporate culture
- A market price
- Freedom to source
- Full flow of information
- Negotiation
  
  Note that when full/arms length negotiation is carried out with full flow of information, the Market Price approach may be the outcome.

**Transfer Pricing: Constraints on Sourcing**

- Limited markets
- Excess or shortage of industry capacity
  - Excess capacity within the firm
    - Converse does not apply
  - Shortage of capacity outside the firm
    - Converse does not apply
- Note that capacity has to be clearly defined
  - Theoretical, Practical, Normal.

**Commonly Used Transfer Prices**

- MARKET PRICE APPROACH
- NEGOTIATED PRICE APPROACH
- COST PRICE APPROACH
- DUAL COST APPROACH
**Market Price Approach**
- Sets the price at which the product transferred could be sold to outside buyers
- Strengths
  - Market-based transfer pricing methods force departmental managers to be as cost-efficient as the best competitor.
- Weaknesses
  - Market-based transfer pricing methods require time and effort because external bids must be acquired and evaluated.
  - Consider the impact of distress pricing on market prices.

**Commonly Used Transfer Prices**
- Transferring products or services at market prices generally leads to optimal decision-making when three conditions are satisfied:
  - the market for the intermediate product is perfectly competitive
  - interdependencies of subunits are minimal
  - there are no additional costs or benefits to the company as a whole from buying or selling in the external market instead of transacting internally.

**Perfectly competitive market**
- A perfectly competitive market exists when there is a homogeneous product with buying prices equal to selling prices, and no individual buyer or seller can affect those prices by their own actions.
- It allows a firm to:
  - Promote goal congruence
  - Motivate management effort
  - Evaluate subunit performance
  - Evaluate subunit autonomy.
**Commonly Used Transfer Prices**

**Distress prices:**
- When supply outstrips demand, market prices may drop.
- If the drop in prices is expected to be temporary, these low market prices are sometimes called 'distress prices'.
- If the price remains low in the long run, and is lower than the variable and fixed costs of production, the production facilities of the selling subunit should be sold, and the buying subunit should purchase the product from an external supplier.

**Imperfect competition:**
- When the market for the intermediate good is imperfectly competitive, the transfer price must generally be set below the external market price (but above the selling division’s cost) to induce efficient transfers.

**Negotiated transfer prices:**
- Occasionally, subunits of a firm are free to negotiate the transfer price between themselves, and then to decide whether to buy and sell internally or deal with external parties.
- May or may not bear any resemblance to cost or market data.
- Often used when market prices are volatile.
- Represent the outcome of a bargaining process between the selling and buying subunits.
- Negotiated transfer pricing policies permit managers to consider factors such as cost and external market prices when negotiating a mutually acceptable transfer price between two business entities.
Negotiated Price Approach

- Advantages
  - Provides the opportunity for achieving the objectives of transfer pricing
  - By providing an integrating mechanism
  - By reducing the need for intervention of centralised management
  - Managers may take advantage of information not held by other managers
  - Performance measures may be distorted by negotiating skills of managers
  - Negotiation consumes considerable time and resources

Note that when full/arms length negotiation is carried out with full flow of information, the Market Price approach may be used.
Negotiation may be seen as a compromise or consensus approach but this is often a “cop-out” solution.

Commonly Used Transfer Prices

Cost price approach

- Uses a variety of cost concepts for setting the transfer price.
  - Variable costs
  - Variable costs plus opportunity costs
  - Absorption (full) cost plus mark-up

Cost price approach

- Advantages
  - Tend to be simple and objective with cost elements readily understood by managers
  - Outside market prices may not be readily available
  - Reduces time and cost of negotiation

- Weaknesses
  - Cost-based transfer pricing methods do not encourage and reward efficiency.
  - Full absorption costing rarely provides accurate information about opportunity costs.
  - Variable costing methods do not provide for appropriate cost recovery.
  - Using full cost plus mark-up or variable cost plus fixed fee, often introduces a negotiated element that offsets the disadvantages of cost based transfer prices
Dual price approach
- Uses two separate transfer pricing methods to price each transfer from one subunit to another.
- Each division uses a transfer price different from other divisions, with any differences being reconciled at head office level.
- For example, the selling division receives a full cost-based price and the buying division pays the market price for the internally transferred products. In the head office accounts the difference is adjusted out.

Commonly Used Transfer Prices

A general guideline for transfer pricing
- It is difficult for a transfer-pricing method to meet all criteria.
- All of the following must be considered simultaneously:
  - market conditions
  - the goal of the transfer-pricing system
  - the criteria of promoting goal congruence
  - motivating management effort
  - evaluating subunit performance
  - preserving subunit autonomy (if desired).
- The transfer price a company eventually chooses depends on the economic circumstances and the decision at hand.

A general guideline for transfer pricing

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Market-based</th>
<th>Cost-based</th>
<th>Negotiated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Achieving goals</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Reducing management office</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Enabling efficient decision-making</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Promoting quick inventory</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Promoting product differentiation</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Other factors</td>
<td>Market may not perturb if market is in demand</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Transfer Pricing Approaches

TRANSFER PRICE = Variable cost per unit + Lost contribution per unit on outside sales

This relationship identifies the minimum and maximum transfer prices

A Transfer Pricing Problem

Assume the following data for division A:
- Capacity in units: 50,000
- Selling price to outside: $15
- Variable cost per unit: $8
- Fixed costs per unit (based on capacity): $5

Division B would like to purchase units from division A. Division B is currently purchasing 5,000 units per year from an outside source at a cost of $14.

1. Assume division A has idle capacity in excess of 10,000 units:
   Minimum transfer price = Variable cost + Lost contribution margin
   = $8 + 0
   = $8

2. Assume division A is working at capacity:
   Transfer Price = Variable cost + Lost contribution margin
   = $8 + $7
   = $15 (market price)

3. Assume division A is working at capacity, but a negotiated $2 in variable costs can be avoided on inter-company sales:
   Transfer Price = Variable cost + Lost contribution margin
   = $6 + $7
   = $13 (negotiated price)

A Transfer Problem Example (Continued)
• The desire of the selling and buying divisions of the same company to optimise their individual performance measures often creates transfer pricing problems
  • Under-utilisation of capacity
  • Loss of expertise

Two types of transfers
• Central services that the receiving unit must accept
• Central services that the receiving unit has the discretion of using or not

• Central services that the receiving unit must accept
• Receiving manager cannot control the efficiency, only the amount of use
  • Use of standard variable cost
  • Use of standard full cost
  • Use of market price
Pricing Corporate Services
- Central services that the receiving unit has the discretion of using or not
- Receiving manager can control both the amount and efficiency of services used

Administration of Transfer Prices
- Negotiation is supported
- Arbitration and conflict resolution
- Product classification
- Product where senior management wishes to control sourcing
- All other products

Transfer Pricing and Service Level Agreements
A service level agreement (SLA) is a contract between two sub-units
- Establish the nature of the service that will be provided by one unit to the other
- Outline the responsibilities of each party
- Price, quality and timing of service delivery, performance targets, problem-solving arrangements, ways in which the agreement can be changed or terminated
- The price of the service is a transfer price, and can be determined using similar methods to those used for the transfer of goods
• Issues related to use of ROI, RI, and EVA
  - Differing profitability measures
  - Differing asset valuation bases
  - The appropriateness of using these measures as evaluation of performance
  - Short term vs long term
  - Issues related to productivity
  - Use of non-financial measures of performance evaluation

Efficacy of Financial Control

READINGS

• Williams, Robert B., Funnell, W., *Transfer pricing and divisional performance evaluation*, Butterworths, Sydney, 1996 657.42 WILL
  - On closed reserve and available as a PDF document in Learnline

Supplementary Readings

Transfer Pricing in Multinationals

• Additional considerations in multinational organisations
  - Taxation
  - Government regulation (particularly in respect to taxation effect)
  - Tariffs
  - Foreign exchange controls
  - Funds accumulation
  - Joint ventures
Transfer Pricing in Multinationals

- **Taxation; Government Regulation; Tariffs; Foreign Exchange Controls Funds Accumulation**
  - Resolve the conflict between Performance Evaluation and Taxation Requirements
  - Ensure objectives are met
  - Make sure all tax requirements are met
  - Handle notifications to tax authorities
  - Provides documentation/defence

Transfer Pricing in Multinationals

- **Finance & Accounting**
  - Address the ability of the financial reporting system to handle implications of transfer pricing
  - Segmented data and budgets
  - Assist in (or takes primary responsibility for) developing and running transfer pricing models
  - Address requirements for accounting systems, accounting rules, consolidation of accounts
  - Administration of invoicing/booking/settlement of intercompany payments

Transfer Pricing in Multinationals

- **Legal**
  - Development of intercompany legal agreements and legal pricing requirements
  - Ensure appropriate legal structure (particularly for Joint Ventures)
Transfer Pricing in Multinationals

- Operations
  - Determining foreign implications of transfer pricing policy
  - Intermediation between local and foreign businesspeople
  - Structure of local core management team
  - Performance evaluation issues in multi-national firms (later topic)

Multinational transfer pricing and tax implications

- 'Transfer Pricing and Taxation', with examples showing how multinationals can use transfer pricing to maximise profits and minimise tax, can be found at:
  http://www.solhaam.org/articles/cm503.html

- ATO – Transfer Pricing
  See also: International transfer pricing - introduction to concepts and risk assessment

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