UNIT 6 TRANSFER PRICING

Objectives

After studying this unit, you should be able to:

• understand and differentiate transfer pricing from external pricing;

• appreciate the need for transfer prices in a situation where two or more divisions exchange goods or services;

• evaluate the different problems of fixing transfer prices in the context of a divisionalised organization; and

• appreciate the importance of transfer pricing in taking correct production and selling decisions.

Structure

6.1 Introduction
6.2 Transfer Pricing and Corporate Policy
6.3 Criteria for Determining Transfer Pricing
6.4 Methods of Transfer Pricing
6.5 Decentralisation and Performance Evaluation
6.6 Transfer Pricing Practices
6.7 Summary
6.8 Key Words
6.9 Self Assessment Questions
6.10 Further Readings

6.1 INTRODUCTION

Large companies, in practice, are divisionalised companies. In other words, they are organized into different divisions for having effective control over them. In such a divisionalised company, where profit or investment center is created, there is likely to be transfer of goods or services from one division to another. Such internal transfers create the problem of pricing the product or service. Thus, if one division supplies its finished output as input to another division the question of transfer pricing arises. Transfer price is the price at which the supplying division prices its transfer of output to the user division. As it is only internal transfer and not a sale, transfer price is different from normal price.

The price charged to the inter-divisional transfer of goods and services is the revenue to selling division and cost to the buying division. Thus, the price charged will affect the profit of both the divisions.

In fact, the benefit (revenue) to one division can be created at the expense of the other division. The transfer pricing does affect the financial performance of different divisions. Therefore, the transfer price should be free from all the biases. It has to be as equitable as possible to the different divisions in the company concerned.
**Activity 1**

a) Note down the conditions which make transfer prices necessary.

b) Can you try to construct a set of objectives for establishing a transfer price system.

---

### 6.2 TRANSFER PRICING AND CORPORATE POLICY

Introduction and operation of an effective system of transfer pricing in an organization is entangled with at least major aspects of corporate policy. They are (1) divisional autonomy, (2) transfer pricing, and (3) performance evaluation. The first two aspects are specific ingredients of general areas of corporate control. Most large organizations may be divisionalised. The divisional managers' freedom of action is not complete. Divisional managers are to make periodic reports to the headquarters. The corporate policy on this may include:

a) the level of details in these reports,

b) the accountability of decisions and actions,

c) the frequency of over-ruling of the divisional manager's decisions, and so on.

The headquarters closely controls those aspects which affect the operations of other divisions. This includes quantities of output transferred among the divisions as also the price at which the transfer takes place (the transfer price).

Apart from control considerations the headquarters must also be concerned with policy regarding evaluation of performance of the divisions. The evaluation of performance of the division is necessary for the 'rewards' and 'punishments' to be decided for the divisional managers. The rewards and punishments of the divisional managers have to be based on some observable objective measures such as sales, profits, cost reductions, innovation, improvements and growth.

The corporate policy determination in the context of divisionalised firms involves two decision-making levels. First the headquarters which sets overall performance evaluation and the corporate control policies and secondly by which set the enterprise level policies relating to discretionary controls such as physical outputs, prices and the like.

The divisional managers who control enterprise level variable would like to maximize their benefits. The benefits depend on the evaluation criteria set by the headquarters. The outcomes depend on the corporate control policies and environment factors. The environment factors such as market condition competition price, taxation and so on are exogenous or given for any enterprises. Most of this environmental variable may be uncertain and will force the divisional manager to take decisions under uncertainty. It is in this context of setting corporate policies relating to evaluation and control that we have to look at transfer pricing and its implications for performance evaluation and corporate control.
Activity 2

Map the relationship of corporate policy issues involved in establishing transfer price system?


6.3 CRITERIA FOR DETERMINING TRANSFER PRICING

It will be advisable to formulate certain criteria before determining the transfer price. Those criteria may be as follows:

1) Transfer price should help in accurate measurement of divisional performance.

2) Transfer price should motivate the divisional managers into maximizing the profitability of their divisions and making decisions which are in the best interest of the organization as a whole.

3) The transfer price should ensure that divisional autonomy and authority is preserved.

4) The transfer price should allow goal congruence to take place. It implies that the objectives of the divisional managers are compatible with the objectives of overall company.

5) A transfer pricing system should check the international groups which may try to manipulate transfer prices between countries with a view to minimize the overall tax burden.

6.4 METHODS OF TRANSFER PRICING

In practice, several methods are used for transfer pricing. However, there are two basic approaches to determination of transfer price. They are: (i) Market based; (ii) Cost based. Let us discuss them briefly, as follows:

Market Price

The most popular method of determining transfer pricing is the market price, as it is quite reasonable for supplying division as well buying division. It is not difficult, as the price is easily available in the open market. When there is a well-established market for the goods or services to be transferred. The transfer price can be easily determined on the market price basis. However, such market price should be taken as ceiling limit for transfer price. When divisions have the alternative to buy or sell from the open market, they would transfer to buy or sell from sister division. When transferred goods are recorded at market price, the divisional performances are more likely to represent the real economic contribution of the division to total company profits.

Under certain conditions, there may be deviations from market-based transfer price. Some instances, for such deviations, are as follows:
• Where the products involved are highly specialized and a ready market does not exist, market-price determination will be more difficult.
• Where it is necessary to take advantage of economies of the scale in the production of some goods or services.
• When it is necessary to shift resources from low priority to high priority divisions.
• Where considerations of taxation are applicable.

Market-based transfer pricing is more commonly used, as it offers following advantages:

• They are one of the most simple and easily understood method.
• They minimize the complications for performance evaluation.
• They reduce points of conflict between various divisions.
• They are usually consistent with the environment outside.

Cost-based Prices

When external markets do not exist or are not available to the company or when correct information about external market prices is not available, the cost based transfer price may be used.

The cost-based prices methods may be as follows:

a) Variable Cost
b) Actual Cost
c) Cost plus a normal mark-up
d) Standard Cost
e) Opportunity Cost

a) Variable Cost

Under this method, only variable production cost is taken into account. In variable cost, the cost of direct material, direct labour and variable factory overhead are included. In other words, fixed cost is not included in it. Variable cost method for transfer price may be useful when the selling division is operating below capacity. However, the selling division manager would not like it as a basis for transfer price, as it does not provide the profit to that division.

b) Actual Cost

If transfer prices based on actual cost, it would include total or full cost of production per unit. It is a simple and convenient method, as the required information is available in the accounting records. However, the selling division would not earn any profit on goods or services transferred to the buying division. The buying division would stand to gain, as it would be lower than the market price. However, it is quite inappropriate for profit center analysis.

c) Cost Plus Normal Mark-up

Under this method, the transfer price include cost per unit plus some profit margin or normal mark-up. This mark-up price may be determined in two ways. Either the management of the company may set a target profit or it may be equal to the profit
Margin that competing firm might reasonably be expected to realize. However, the decision about the ‘percentage’ of mark-up may be arbitrary and questionable.

d) **Standard Cost**

Standard Cost is pre-determined cost and is also called 'engineered cost'. In practice, it may appear to be more practical and useful and may be taken to be a good choice for transfer price. Standard cost based transfer price encourages efficiency in the selling division as inefficiencies are not transferred on to the buying division. Use of standard cost reduces the risk to the buyer.

e) **Opportunity Cost**

Often in practice, the determination of transfer price on market price or cost may be difficult. Under those circumstances, the transfer price may be based on opportunity cost. Such pricing may also be required where the supplier division is a monopoly producer or the user division is a monopoly consumer.

The transfer price may be fixed at a level which equal the opportunity cost of the supplier division and the user division. It also identifies the minimum price that a selling division will be willing to accept and the buying division will be willing to pay.

The opportunity costs based on transfer prices for each division are as follows:

**Selling Division:** For the selling division, the opportunity cost of transferring is the greater of:

- The outside sales value of the transferred product;
- Differential production cost for the transferred product.

**Buying Division:** For the buying division, the opportunity cost of acquiring by transfer is the lesser of:

- The price that would be required to purchase from the outside;
- The profit that would be lost for producing the final product if the transferred unit could not be obtained at economic price.

In the economic interest of the company, it would be better if the opportunity cost for the selling division is less than the opportunity cost for the buying division. The practical difficulty may arise when the divisions will tend to overstate or understate their opportunity cost so as to influence the transfer price to their advantage. Under such condition, the central management may examine it and bring the necessary changes by obtaining necessary information in this regard.

There are two other methods of determining the transfer price. They have been described briefly as follows:

1) **Negotiated Prices**

In practice, the transfer price is determined on the basis of negotiations between the selling and buying division. It may be between the market prices and the cost-based price. While negotiating the price, the seller division manager and buying division manager act much the same as the managers of independent companies.

If the transfer price is based on negotiated price, the company, as a whole, stands to benefit. Such price avoids mistrusts, bad feeling and undesirable bargaining interest among divisional managers. It provides an opportunity to achieve the objectives of goal congruence, autonomy and accurate performance evaluation.
The negotiated price basis may have some limitations also. They are:

- In the process of negotiation, a great deal of management effort, time and resources may be consumed.
- Such a price may also depend upon the skill and ability of managers concerned.
- One divisional manager may take advantage of having some private information which the other manager may not possess. With the result, the negotiated price may not be accurate.

2) Dual Prices

It is also known as 'two-way prices'. Under this method the selling division is credited with one price. That may be cost plus profit margin whereas the buying division is charged at different price, which may be equal to variable cost. The difference in the transfer prices for the two divisions could be accounted for by a centralized account. The dual pricing gives motivation and incentive to selling division as goods are transferred at cost plus some profit margin. On the other hand, for the buying division, it would be quite appropriate price.

Often, the use of dual prices may lead to a divergence between the segment profits and those of company. However, this is not a serious issue and can be resolved in the interest of the divisions concerned.

Activity 3

i) What conditions must exist for establishment transfer price based on the following?
   a) market price or modified market price
   b) different cost-based transfer prices
   c) negotiated transfer price
   d) opportunity-cost-based transfer price

ii) Prepare a matrix showing different transfer pricing models, situations ideal for each case, and advantages and problems of using different transfer prices.

6.5 DECENTRALISATION AND PERFORMANCE EVALUATION

Every organization aims at achievement of some group-objectives. An important consideration in organizing activities is the congruity between the objectives of the individuals in the group and the group. Where such congruity exists the group goals would be achieved automatically with the achievement of personal goals.

In reality, however is a natural contradiction between individual goals and the group goals. A basic contradiction which can be easily understood is the fact that the
individual tends to want to put a small part of effort into achievement of the
group's goals and at the same time like to share a larger part of the benefits of the
group's activities. It is in the context of this natural tendency that the group must
impose some performance evaluation of the individual. The share of the individual
in group-achieved benefits (or results) should be proportional to some observable
contributions of the individual to the group's objectives. The group activities are
to be left to the individuals and what success criteria are to be considered in the
evaluation of the contribution made by the individual towards the group. The
activity of the group to be left to the individual's decision will determine the
degree of individual autonomy. The success criteria to be used for evaluating the
individual's contribution to the group will determine the method of performance
evaluation.

The set of observable success criteria may be taken to include absolute profit
levels, profit rates, cost levels, revenues, market share, product improvements,
increase in productivity and so on. Managers on the other hand base their controls
on various variables such as quantities of inputs purchased and consumed,
quantities of output produced, prices obtained on outputs, expense incurred on
marketing, research and development, product improvements and so on. Please
recall the overall performance evaluation given for various types of responsibility
centers in Table 4.1

It is generally agreed that there are three major principles for developing and
implementing performance evaluation system:

1) The criteria and procedure of performance evaluation should be clear and
   explicit and the superior and subordinate should have common
   understanding prior to the beginning of the evaluation period.

2) The criteria of performance evaluation should be as accurate possible.

3) It is ideal to use a multiple criteria of performance than any single criteria.

If we look at the control variables used by responsibility centres in Table 4.2 (in
unit 4) we notice that in case of all the centres in a multi divisional organization -
using or providing goods or services from or to another division --the performance
measurement will be closely linked to the transfer pricing used by the
organization. It is this central position of transfer pricing in the performance of
evaluation of different divisions and the resultant organizational problems that
makes it very crucial in the scheme of performance evaluation.

Activity 4

What are the problems which come up in transfer pricing in the area of performance
evaluation.

6.6 TRANSFER PRICING PRACTICES

There is a large amount of documented sources on the transfer pricing policies used
by companies all over the world. These studies have documented various aspects
of transfer pricing policies such as (a) its role as an overall component of
reporting and control system in companies, (b) the effect of transfer pricing on
intra-corporate conflicts, (c) variations in transfer pricing policies across the
world, and (d) environment constraints on use of transfer prices.
A brief summary of transfer pricing practices is as follows:

1) Companies tend to look at transfer pricing not just as a mere accounting exercise, but also as an important tool in policy formulation towards achievement of corporate objectives.

2) Transfer pricing acts as a major source of political conflict within the organization and this takes place irrespective of the method used for this purpose. Different methods may, however, increase or decrease the possibility of conflict.

3) Companies tend to use a variety of transfer pricing methods. However, the dominant among them are the market prices or the methods based on modifications of the market prices.

4) Even though many companies use transfer prices as a policy variable, it is not the major or principal policy variable.

5) International companies use conscious manipulation of transfer prices as an instrument of maximizing achievement of corporate goals. An explicit example is the transfer of profits from subsidiaries to parent companies or other companies in the group through transfer pricing policies relating to supply of capital equipment or inputs by multinational companies.

6.7 SUMMARY

Large businesses are usually organized into divisions for effective management control. When the organizations get divisionalised, they face the problem of pricing the goods and services 'purchased' by one division from another from within the organization.

Transfer price is the price establishment for inter-divisional transfer of goods or services. The processes of setting transfer prices are closely related to the corporate policies on divisional autonomy and performance evaluation.

There are various methods of transfer pricing that can be used by an organization. However, the choice will be determined by a host of factors such as nature of the product; policy of the company with respect to divisional autonomy, method of performance evaluation, and so on. The usual methods are based on cost of production, market prices, negotiated prices or opportunity cost supplier and user divisions. It is common practice to use any one of these methods as a basis and then to determine the actual transfer price by appropriate mutually agreed adjustments in the context of a particular company.

Transfer pricing has a direct impact on the issue of performance evaluation to be used by the company and hence is closely related to the question of motivation of the executives. In actual practice companies use almost all the methods. The choice of methods is determined by the management policy and the particular situation of the company. Most commonly used methods are based on market prices. Companies consider transfer pricing important to the policy formulation for achieving the objectives of the company. The internal political structure of the organization also plays a part.

Illustration

The Apparels division of Ibis Apparels uses yarn from Ibis Yarns, the spinning division which is operating at full capacity. The yarns division sells part of its output to regular outside customers at Rs. 15.00 a unit. Apparels division has now offered Rs. 10.00 a unit for the yarn. It sells its products in the open market only.

The cost structure of Apparel Division is estimated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>Rs. 100</td>
</tr>
<tr>
<td>Outside supplies</td>
<td>40</td>
</tr>
<tr>
<td>Ibis yarn supplies</td>
<td>10*</td>
</tr>
<tr>
<td>Other variable costs</td>
<td>15</td>
</tr>
<tr>
<td>Fixed overheads</td>
<td>Rs. 95</td>
</tr>
</tbody>
</table>
Transfer Pricing

The Apparels Division is operating at about 50 per cent of its capacity and the divisional management believes that a saving of Rs. 5.00 per unit of yarn which is a major part of the Apparel Division's input, can give it a price advantage in the market and will be able to increase its capacity utilization.

The company uses return on investment to measure the financial performance of divisional managers.

1) Assuming that you are the divisional manager of Ibis Yarns, will agree to selling yarn at Rs. 10.00 to Apparel Division? Why or Why not?

2) Will it be the immediate economic advantage of Apparel Division if the yarn division supplied yarn at Rs. 10.0 per unit? Explain.

3) Can you evaluate the management issue involved in this situation? What will be your stand if you were the President of Ibis Company?

Suggested answer

a) It is advisable to supply Apparel Division with yarn at the rate of Rs. 10.00 per unit. Yarn Division will lose Rs. 5.00 per unit on quantity sold to Apparel division. The performance of yarn division will be adversely affected as it is be evaluated on the basis of return on investment.

b) The nature of Rs, 15.00 per unit fixed cost is the key to the question of deciding what is good for Apparel Division. These costs are to be incurred, irrespective of the volume of operations. Thus, even if the yarn is purchased at Rs. 15.00 per unit and a price cut of Rs. 5.00 is effect to increase the sales the contribution will still be positive as shown below:

<table>
<thead>
<tr>
<th>Selling price</th>
<th>Rs. 95</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: variable costs:</td>
<td></td>
</tr>
<tr>
<td>Outside supplies</td>
<td>- 40</td>
</tr>
<tr>
<td>Ibis yarn's supplies</td>
<td>- 15</td>
</tr>
<tr>
<td>Other variable costs</td>
<td>- 30</td>
</tr>
<tr>
<td>Contribution margin</td>
<td>Rs. 10</td>
</tr>
</tbody>
</table>

The Apparel Division has a positive contribution of Rs. 10 per unit even after obtaining the yarn at market price and effecting the required reduction in price to effect expansion in sales volume. Correct analysis will show that it is not necessary to obtain a price advantage of Rs. 5 per unit from yarn division to make the price reduction possible.

There is no immediate advantage to be obtained by Yarn Division supplying the yarn at Rs. 10.

c) The best interest of the Ibis company is served by the apparel division effecting the price cut to increase the volume and thereby reducing the per unit incidence of fixed costs.

Forcing the Yarn Division to supply at Rs. 10 per unit is not a valid argument since there is no real advantage to the company as a whole.

As the president of the company I would ask the Apparel Division to look elsewhere for maximizing the margins than by artificially increasing the same by temporary Vail out from another division.
6.8 KEY WORDS

**Cost Based Transfer Price**: A price determined for inter-divisional transfer of goods or services which are based on cost of such goods or services with or without the additional of a margin on the cost. Either the whole or some predetermined components of the cost from the base of such transfer prices.

**Market Price Transfer Prices**: A price determined for inter-divisional transfer of goods or services which are based on the market price of such goods or services, with or without any adjustment. Market price may be determined by the adjustment to be carried out.

**Negotiated Price**: A price for inter-divisional transfer of goods or services which are determined by negotiations between supplying and divisions. A price established in an 'arms length negotiations between supplying and user divisions. A price established in an 'arms length negotiation' is a free and as if these divisions where two independent parties to the transaction.

**Transfer Price**: An internal selling price established for goods or services transferred between divisions of a divisionalised company.

6.9 SELF ASSESSMENT QUESTIONS

Steel Industries Ltd. (SIL) was formed by merging three independent units, Mini Steels Ltd. (MSL), Steel Rolling Ltd. (SRL) and Steel Fabricators Ltd. (SFL).

After the merger in 19XI the three units have operated as three divisions of SIL, as if they were independent units, having own sales force and production facilities. Each division management is responsible for sales, costs of operations, financing and working capital management.

SF division received a contract for structural fabrications. It uses rolled components from SR division. It also uses components from outside suppliers. SF used a cost figures of Rs. 3,800 per ton for the rolled products manufactured by SR in preparing the bid for the contract. This cost was based on the information relating to standard variable cost of manufacturing, selling and distribution supplies by SR.

SR has an aggressive production and sales force catering to new rolled products according to the market demand. SR's average selling price for the rolled products to be supplied to SR is Rs. 6,500. Sales of these components are growing in the market. SR has offered to meet the demand of SR regularly at the current selling price less variable selling and distribution expenses. SR has offered to pay standard variable manufacturing cost plus 20%.

The corporate management had so far never set a transfer price since the divisions had continued with their independence even after merger. Since the two divisions, now could not agree on the price, the corporate finance director intervened and suggested a price based on standard full manufacturing cost plus a mark up of 15%.

Needless to say both the divisions rejected the compromise suggestion. The cost structure of SR division's rolled components to be supplied to SF division and the three suggested transfer price are given below:
Current market selling price $\text{Rs. 6,500}$

Variable manufacturing cost $\text{Rs. 3,200}$

Fixed manufacturing cost $1,200$

Variable selling and distribution cost $600$

$\text{Rs. 5,000}$

Transfer Price alternative:

Current market price less variable selling and distribution expenses ($\text{Rs. 6,500 - 600}$) $\text{Rs. 5,900}$

Variable manufacturing cost plus 20% ($\text{Rs. 3,000 x 1.2}$) $\text{Rs. 3,840}$

Full manufacturing cost plus 15% ($\text{Rs. 4,400 x 1.15}$) $\text{Rs. 5,060}$

**Required**

1) Discuss the effect of each of the suggested transfer prices on the SR division. What would be the attitude of SR division towards intra company sales?

2) Do you agree with the process of negotiation between SR and SR divisions as satisfactory method of resolving the transfer price question? Explain your position.

3) What is the role of corporate management in the situation? Will you agree to the suggestion of imposing a transfer price in this situation? Explain your answer.

**6.10 FURTHER READINGS**


Wells, M.C., 'Profit Centre, Transfer Prices and Mysticism', *Abacus*, 4, December.