PRICING DECISIONS

Transfer pricing

A transfer price is the price at which goods or services are transferred from one division to another within the same organisation.

Objectives of a transfer pricing system

i. Goal congruence

The decisions made by each profit centre manager should be consistent with the objectives of the organisation as a whole, i.e. the transfer price should assist in maximising overall company profits.

A common feature of exam questions is that a transfer price is set that results in sub-optimal behaviour. For example, the buying division may be encouraged to purchase from an external source, rather than the internal selling division, because the transfer price is set too high. This could reduce overall company profits despite being the best option for the selling division.

ii. Performance measurement

The buying and selling divisions will be treated as profit centres. The transfer price should allow the performance of each division to be assessed fairly. Divisional managers will be demotivated if this is not achieved.

iii. Autonomy

The system used to set transfer prices should seek to maintain the autonomy of profit centre managers. If autonomy is maintained, managers tend to be more highly motivated but sub-optimal decisions may be made. For example, managers may make the decision to buy or sell externally, when an internal transfer would benefit the company more.

iv. Recording the movement of goods and services

In practice, an extremely important function of the transfer pricing system is simply to assist in recording the movement of goods and services between divisions.

The impact of a transfer price

Transfer pricing does nothing more than move profits from one division

to another.

For example, consider a company with two divisions, A and B, where A makes a product for Shs.10 per unit and B sells 1,000 units for Shs.25 each. If there was no transfer price, then the divisional profits/losses and the total profit/loss for the company would be as follows:

	Division A	Division B	Company total
	Shs.	Shs.	Shs.
Sales (1,000 × Shs.25)	–	25,000	25,000
Costs (1,000 × Shs.10)	(10,000)	–	(10,000)
Profit/(loss)	(10,000)	25,000	15,000

If, instead we were to introduce a transfer price of Shs.15 per unit (i.e. B must pay A Shs.15 for each unit produced) then the divisional and company profits would be as follows:

	Division A	Division B	Company total
	Shs.	Shs.	Shs.
Sales (1,000 × Shs.15)	15,000	25,000	25,000
Costs (1,000 × Shs.15)	(10,000)	(15,000)	(10,000)
Profit/(loss)	5,000	10,000	15,000

* the transfer price is ignored in determining the company totals. It can be seen that the transfer price has had no impact on overall company profits. But Shs.15,000 (10,000 units at Shs.15 per unit transfer price) has been transferred from division B to division A.

Setting the transfer price

Methods of Transfer pricing

- ✓ Market based
- ✓ Negotiated method
- ✓ Cost-based method
- ✓ Dual-rate costing method

Market based approach

If an external market exists for the transferred goods, then the transfer price could be set at the external market price.

Advantages of this method:

 The transfer price should be deemed to be fair by the managers of the buying and selling divisions. The selling division will receive the same amount for any internal or external sales. The buying division will pay the same for goods if they buy them internally or externally.

 The company's performance will not be impacted negatively by the transfer price because the transfer price is the same as the external market price.

Disadvantages of this method:

 There may not be an external market price.

 The external market price may not be stable. For example, discounts may be offered to certain customers or for bulk orders.

 Savings may be made from transferring the goods internally. For example, delivery costs will be saved. These savings should ideally be deducted from the external market price before a transfer price is set, giving an "adjusted market price".

Cost based approach

The transferring division would supply the goods at cost plus a % profit. A standard cost should be used rather than the actual cost since:

 Actual costs do not encourage the selling division to control costs.

 If a standard cost is used, the buying division will know the cost in advance and can therefore budget accordingly.

There are a number of different standard costs that could be used:

 Full cost

 Marginal (variable) cost

 Opportunity cost.

Each of these will be reviewed in the following examples.