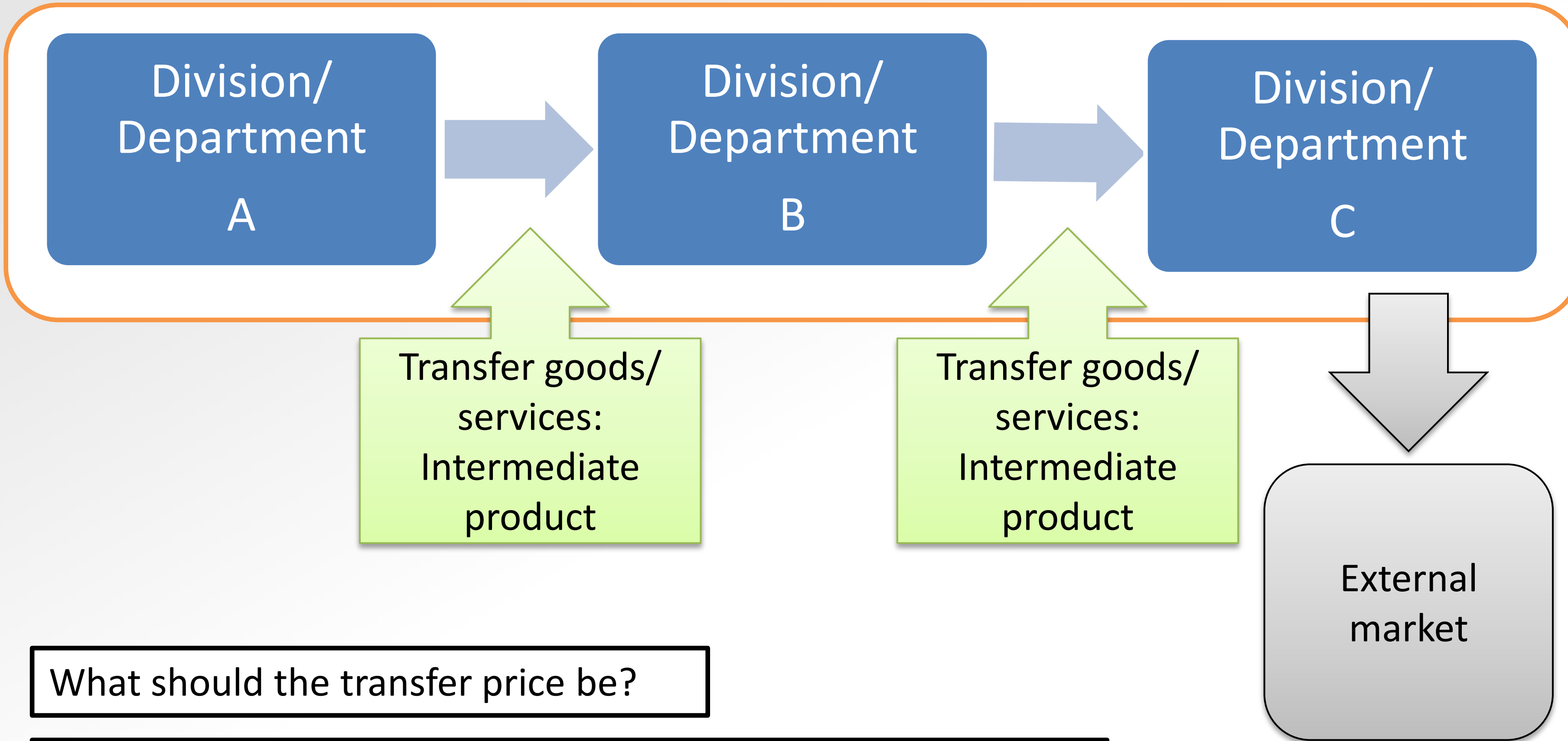
Transfer Pricing

Purpose of Transfer Pricing

- Provide information that motivates divisional mangers to make good economic decisions
- Provide information that is useful for evaluating the managerial and economic performance of the divisions
- To intentionally move profits between divisions or locations
- To ensure that divisional autonomy is not undermined

What is Transfer Pricing?



What should the transfer price be?

Recommendation: RANGE of transfer prices!

Transfer Pricing implications

- Divisional autonomy
  - want divisions to make their own decisions
- Performance evaluation
  - Transfer price affects profit of each division, therefore has a direct effect on performance evaluation of each division
- Have to ensure act in best interests of GROUP, while still making optimal decision for division
  - i.e. Buyer must still be able to make a profit (own best interest) so still acts in best interest of company

T/P = variable cost

T/P = cost + mark up %

Alternative Transfer Pricing Options

- Market Based Measures
- Marginal Cost Transfer Prices
- Full Cost Transfer Prices
- Cost-Plus a Mark up Transfer Price
- Negotiated Transfer Prices

Alternative transfer pricing methods

Variable costs

Fixed costs

Profit markup

Market price

Marginal cost

Full Cost

Estimate fixed costs, volume?

Cost plus mark-up

Negotia-ted

Minimum

Negotiate

Summary – Transfer Price?

- Transfer Price?
  - Minimum TP *(Seller)*
    - **Spare capacity:** TP= Variable cost of supplying division
    - **No Spare Capacity:** TP= variable cost + opportunity cost of supplying division
  - Maximum TP *(Buyer)*
    - **Price Elasticity:** Break even occurs when contribution of best option = contribution of 2nd best option
    - **No Price Elasticity:** Breakeven will be at buyer's break even (NMR of buyer = TP) OR Market price of intermediate product

Maximum Transfer Price – No market for Intermediate product

No price elasticity

- This is the price at which receiving division does not make a contribution
- Use the formula to solve for TP
- $(SP-VC-TP)Qty = 0$

Price Elasticity

- Transfer price is set a price where they are indifferent about the two best options
- $(SP-VC-TP)_1 Qty_1 = (SP-VC-TP)_2 Qty_2$

DETAILED EXAMPLE

- Division C is a profit centre that produces products X, Y and Z with each of the products having an external market. Product details:

	X	Y	Z
External market price	$48	$46	$40
Variable cost of production in division A	$33	$24	$28
Labour hours required per unit in division A	3	4	2

- Product Y can be transferred to division N, but the maximum that might be required by N is 300units of Y. The maximum external sales are 800units of X;500units of Y;and 300 units- Z N could buy similar units of Y from an external supplier for $45 .

1. Required: What should the transfer price be if the total labour hours available in division C are (a) 3800hrs and (b) 5600hrs

Illustrative Example

Landual Lamps (Landual) manufactures and delivers floor and table lamps for homes and offices in Beeland. The company sells through its website and uses commercial logistics firms to deliver their products. The markets for its products are highly competitive. The company has traditionally relied on the high quality of its designs to drive demand for its products.

The company is divided into two divisions (components and assembly), plus a head office that provides design, administrative and marketing support. The manufacturing process involves:

1 The components division making the housing components and electrical components for the lamp. This is an intricate process as it depends on the specific design of the lamp and so serves as a significant source of competitive advantage for Landual

2 The assembly division assembling the various components into a finished lamp ready for shipment. This is a simple process.

The finance director (FD) of Landual is currently overloaded with work due to changes in financial accounting policies that are being considered at board level. As a result, she has been unable to look at certain management accounting aspects of the business and has asked you to do a review of the transfer pricing policy between the components and assembly divisions.

The current transfer pricing policy at Landual is as follows:

(a) Market prices for electrical components are used as these are generic components for which there is a competitive external market.

(b) Prices for housing components based on total actual production costs to the components division are used as there is no external market for these components since they are specially designed for Landual's products.

Currently, the components division produces only for the assembly division in order to meet overall demand without the use of external suppliers for housing and electrical components. If the components division were to sell its electrical components externally, then additional costs of $269,000 would arise for transport, marketing and bad debts.

The FD is considering two separate changes within Landual: one to the transfer pricing policy, and a second one to the divisional structure.

First, the transfer pricing policy for housing components would change to use variable cost to the components division. The FD wants to know the impact of the change in transfer pricing policy on the existing results of the two divisions and the company. (No change is proposed to the transfer price of the electrical components.)

(a) Evaluate the current system of transfer pricing at Landual, using illustrative calculations as appropriate. **(10 marks)**

(b) Advise the finance director (FD) on the impact of changing the transfer pricing policy for housing components as suggested by the FD and comment on your results, using illustrative calculations as appropriate.