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A Study of the Bases for Choosing a Cost Based Transfer Price in Organisations in Ilorin

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Abstract

All cost based transfer prices have shortcomings, but organizations do choose one among them. This demonstrates that other reasons abound for choosing other than strength. This study is set out to determine the bases for the choices. The objective of the research, in general terms, is to determine whether strength of the transfer pricing method or requirement is the factor considered in choosing a transfer price that is based on cost.

Primary data are used for the study. They are gathered from decentralized organizations through questionnaire administration. Chi-square was computed to analyse the data generated for hypothesis testing. The findings include that neither cost based transfer prices nor profit measure of divisional performance is chosen based on their strength, but choice of one depends on the other. The study concludes that the choice of transfer prices is a matter of requirement and recommends the consideration of all surrounding circumstances, of which profit measure of divisional performance is only a part, when choosing a transfer price that is based on cost.

Background to the study

The price of goods and services of an organization determines its revenue and consequently its profit. This means that ability to make efficient decisions as regards price largely determines the organisation's final profitability and eventually, survival. Price "refers only to the monetary or exchange value of the commodity or facility acquired" (Lawal, 1982). In other words, it is the amount of money you pay to buy something 'Something' here logically includes goods as well as services. Decision relating to pricing is a vital one, because it is one of the important factors determining the revenue of an enterprise. The consequence of price importance is the reason for it's, usually, being the responsibility of top management.

Two types of pricing decisions face most firms. Those for the external sales of final products and for internally transferred intermediate goods and services between parts of the organization (Lacey, 1996). The first pricing decision is referred to as external pricing while the other, which is the subject of study here, is referred to as internal or transfer pricing.

Fixing a transfer price that will satisfy supplying division, and at the same time not altering the general goal of an organization has been a subject of discussion for a very long time now and several models have been designed in this line. Among the several models suggested is the cost based model. Like all other models, the cost-based models have shortcomings. This is because all methods under it have one drawback or the other. All of these methods, however, have their place in one organization or the other despite the shortcomings. This automatically scales down the question of one being superior to the other as emphasized by past research, and springs up the search for empirical reasons behind choices.

American institute of certified public accountant's report stated that cost-plus mark up transfer price is the best of cost based transfer prices (Abdel-Khalik and Lusk, 1974). The statement has the consequences of making organizations move towards adoption of the bases which in actual sense may not be the best in all circumstances. The problem of emphasis here is the fact that choice of transfer price based on strength may be defective without considering other surrounding factors.

The objective of this study is therefore to determine whether the choice of a cost based transfer price is borne out of analysis of strength and weaknesses or because of the specific requirement of a particular enterprise. The specific objectives of the study are to:

- Describe methods of setting transfer prices,
- Evaluate cost-based transfer prices,
- Describe cost as related to different divisional profitability measurement,
- Determine the effect of profitability measure requirement on choice of a transfer price, and
- Make recommendations based on the conclusions drawn.

Many authors have carried out research on transfer pricing in the past. Efforts in this study is at advancing further research by empirically studying the effect of profit measure of divisional performance on choice of transfer price in the study area.

Statement of hypotheses

The following hypothesis are tested to arrive at the findings:

- Hypothesis 1
H₀-choice of a cost based transfer price is not based on its strength and superiority over others.
H₁-choice of a cost based transfer price is based on its strength and superiority over others.
- Hypothesis 2
H₀-choice of a cost based transfer price is not based on profitability pressure requirement of the enterprise
H₁-choice of a cost based transfer price is based on profitability pressure requirement of the enterprise
- Hypothesis 3
H₀-choice of a cost based transfer price is not based on profitability pressure requirement of the enterprise
H₁-choice of a cost based transfer price is based on profitability pressure requirement of the enterprise

The remaining part of this paper is divided into three sections. Section two is for review of related literature that has discussed transfer pricing, the need and condition for setting transfer prices, its determination models, cost base transfer prices and their short falls and different types of profit based divisional performance appraisal. The methodology of the study is discussed in the third part while the final part is for result of data analysis, discussion of findings and conclusion.

Literature Review

Concept of transfer pricing

Transfer pricing according to Lucey (1996) "is the process of determining the price at which goods are transferred from one profit center to another profit center within an organization." A transfer price represents a cost to the receiving division and revenue to the supplying division, of intermediate products. According to Abdel-Khalik and Lusk (1974), transfer-pricing system is about general pricing for internally produced and consumed commodities. It becomes of interest if the cost of the commodities transferred is material and when profitability is an important consideration in divisional performance evaluation.

Need for Study in Transfer Pricing

Transfer pricing did not just evolve as a subject for study, but first because of the existence of intermediate products. The fact that one division supplies the other is not also the only cause of

transfer pricing but rather decentralization. As set forth by Drury (2000), the decision to process forward or not in a centralized environment "is determined by comparing the incremental cost of and the revenues from further processing; and not by transfer pricing". Therefore, the fact that a product (intermediate) exists to be transferred between divisions of a decentralized organization calls for unbiased transfer pricing decision. Further to this reason is where, as stated by Onsi (1970), profit is a basis for divisional manager's performance evaluation and incentive compensation is based on that profit.

Purposes of transfer pricing

The purposes, which a transfer pricing system is required to meet according to Drury (2000), include:

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

In what seems like giving a condition for transfer pricing system, Abdelkhalik and Lusk (1974) Quoted stone as saying, "In conceptualizing the transfer pricing problem, it was argued that a rationally conceived and systematically applied transfer pricing system would enable divisions to maintain their autonomy while making decisions that benefit the entire organization".

In the words of Ronen and McKinney (1970) the following conditions are required to be satisfied when setting transfer-pricing system for a profit center.

- Transfer pricing must allow for accurate performance evaluation of profit centers.
- It must allow for profit center managers to pursue own interest in a manner conducive to company's goal congruence
- The system must serve as a stimulus to managers to increase efficiency without losing autonomy

Transfer Pricing Determination Models and their Shortfalls

Economic pricing model

This model could be explained from Onsi (1970) and Abdel-Khalik and Lusk (1974) views. Pricing here falls into two parts, where there exists an intermediate market and where there exists not. Where a market exists for the intermediate products economists are of the opinion that the market price for the intermediate product should be the transfer price and where there exists not, the marginal cost curve should be used. Here the transfer price is set at the point where marginal cost of the supplying center equal marginal net revenue of the receiving center (i.e. $TP = MC'S = MR'R$).

Where TP is transfer price, MC'S is cost of supplying center, MR'R is revenue of receiving center.

Some of the short falls of the economic model according to Onsi are:

- The unrealistic assumption of 'no constraint' for producing at marginal cost equals marginal revenue.
- The supplying center adjust its level of accuracy in estimating variable cost according to its belief in the accuracy of other centers.
- The economic model, according Abdel-khalik and Lusk (1974) is limited by its composition of marginal cost in the sense that, marginal cost from the point of view of economists, contains some elements of fixed cost which is contrary to accountants' point of view. This, they said, will necessitate further adjustment to accounting marginal cost.

Mathematical Programming Approach.

As stated in the article by Abdel-khalik and Lusk (1974) Linear programming model and decomposition principle are considerable here. The two determine transfer price based on opportunity cost of intermediate product, which shadow price provides measure for.

Linear programming suffers from over centralization and it is also complicated by its requirement of a modified accounting system that accommodates information flows between autonomous units. Although decomposition is said to be an improvement to linear programming, it is also said that it does not assure complete decentralization.

Negotiated Pricing

The work of Charles and Haka (1990) were concentrated on negotiated transfer pricing. The method according to them is a result of bargaining between the two managers (the supply and the receiving). One short fall of negotiated pricing model is Charles and Haka (1990) finding that it does not always attain the desired objective of the companies, pertaining to maximization of profit and equitable divisional performance appraisal. Abdel-Khalik and Lusk stated that negotiated transfer pricing model does not allow for real performance evaluation rather evaluation of power to negotiate.

Dual Pricing Model

According to Drury (2000) the model uses two separate transfer prices for each inter-divisional transaction. The supplying price recorded is different from receiving price recorded for the same transaction. The short falls of this model, according to him, include:

- Confusion, particularly with more than two divisions
- They are considered to be artificial, and
- A disincentive to effective competition.

Cost Based Transfer Pricing

Price determination generally considers cost as an important factor. Hilton (1988)'s work is about product costing choice of individual decision maker in setting prices. Considering the two methods, product costs computed under variable costing approach provide better surrogates for marginal cost than do product costs computed under an absorption costing approach. But survey report according to him shows a considerable usage of absorption costing as a basis for setting product price. Risk attitude of individual decision-making, he found out, determines whether to use absorption or direct costing as a basis.

As the costing method affects final pricing so also it does for transfer pricing. Drury (2000) identified the following cost based transfer-pricing methods:

- Marginal cost transfer prices: cost reflected in here is short run variable cost which composed of direct cost and variable indirect cost.
- Full cost transfer prices: "represent the sum of the cost of all of those resources that are committed to a product or service in the long run"
- Cost plus a mark-up transfer prices: profit element is added to full cost to enhance performance measurements.

Marginal cost transfer pricing

As set forth by Drury (2000), with the existence of market for intermediate product, marginal cost transfer prices can motivate both supplying and receiving division to operate at levels which maximize overall company profits. Economic theory, according to him, indicates that mathematically correct transfer price will encourage total organizational optimality, in the absence of capacity constraints. It will ensure that the marginal cost of producing the intermediate product at the optimal output level of the company as a whole is maintained.

Because accountants have adopted a short term perspective to devising marginal cost, with consistent marginal cost per unit of output, he stated that "the theoretically correct transfer price can be interpreted as being equivalent to the variable cost of the supplying division".

Price here would be: $TP = MC = VC$

Where: TP = Transfer Price, MC = Marginal cost and VC = Variable cost

The problems of this method include that it does not support the profit or investment responsibility structure because it provides poor information for evaluating the two divisions concerned. Also marginal cost may not be constant over the entire range of output because of step increase in fixed cost that may occur (Drury, 2000).

Full Cost Transfer Prices

Where management cost transfer price take a short term perspective, full cost transfer prices display manager's view of product related decision as being a long - run type and requires long - run marginal cost. It was stated that 'the practice of transfer pricing above variable cost may be quite consistent with pricing at the economists marginal cost. This statement is with the assumption that the accountant's marginal cost, which equals variable cost, is the basis for determining marginal cost transfer prices. Some costs that are not considered in the accountant's marginal cost include extra wear and tear on plant caused by increased production, which they treat as depreciation. This would be made part of marginal cost for transfer pricing by absorption of fixed cost. Also other costs are treated as fixed cost, rather than tracing them to their causal transaction. If these costs were functions of output level, the variable cost would have been under estimated.

Price here would be: $TP = AFC + AVC$

Where: AFC = Average fixed cost, AVC = Average variable cost

Full-allocated cost approach may be, in the light of above, better approximation to true marginal cost. With it, it will be better to establish well accurately what the nature of all cost functions are and then relate them to their specific transaction and hence to changes in output levels.

One problem with full cost transfer price is that it is derived from traditional costing system, which can provide poor estimate of long run marginal cost. Another is that they do not provide incentive for the supplying division to transfer goods and services, internally because there is no profit margin. It will understate supplying divisions profit if the transfer is significant (Drury 2002).

Cost plus a Mark-up Transfer prices

This represents an attempt to meet the performance evaluation purpose of transfer pricing by enabling the supplying division to make profit on goods transferred. The full cost is used as the base and a mark-up is added to provide a profit margin for the supplying division. If variable cost is used as cost-base the mark up will cover both fixed cost and a profit contribution.

Price here would be: $TP = AFC + AVC + CM$

Where: AFC = Average fixed cost, AVC = Average variable cost and CM = Contribution

Because of the composition of the margin that covers short-run or long-run variable costs, transfer price here will cause inter divisional transfer to be less than the optimal level for the company as a whole. A further problem arises if the analysis extends beyond two divisions.

Abdel-Khalik and Lusk (1974) however found cost plus to have the following limitations:

- Arbitrary allocation of joint and fixed cost
- Implied willingness to incorporate possible inefficiency
- Assumption that opportunity cost is not different from average cost plus or ignoring opportunity cost
- Impediment to technological progress by manufacturing division

- Dictability by management of mark-up will disregard responses if demand is elastic to different rates.

Profit measures of divisional performance

When profitability is used for divisional performance measurement, Lucey (1996) identified some variety of ways in which profit is defined, as, controllable profit, divisional profit, net profit, controllable residual profit and net residual profit. A study of his description of the profit types show their differences as being in the manner costs are charged to profit. Costs combined in different forms and charged to profit in his work include direct cost, variable cost, divisional overhead cost, central administrative cost and depreciation and fixed asset costs. All these costs could fit in to direct, variable or fixed costs.

Variable short run contribution

According to Drury, variable short run contribution is determined giving consideration to revenue and variable costs only, it does not include fixed costs that are controllable at divisional level. He considered it not appropriate for performance evaluation ($R - VC = CM$).

Controllable Profit

Lucey describes controllable Profit as revenue less cost controllable at the divisional level. He stated further that the measure include only those costs and revenues for which local management is responsible. The cost considered include variable cost and revenues for which local management has primary responsibility. With this variable costs and divisional overheads that are controllable, locally, shall be included ($R - VC - OH = CM$).

Divisional Profit /Contribution

Divisional Profit is also known as traceable profit or direct profit. They arise from divisional operations, which can be calculated without arbitrarily apportioned central costs. Divisional profit/contribution takes depreciation and other non-controllable divisional overheads into consideration ($R - VC - OH - DEP = CM$).

Net Profit

Lucey defined Net profits as revenues less controllable divisional costs and apportioned central administration costs. All costs, variable overheads, depreciation and fixed asset costs and apportioned items are considered in determining this ($R - VC - OH - DEP - AC = CM$).

Where Drury favour divisional contribution while faulting arbitrary tendencies there in, Lucey tends to favour controllable contribution for divisional performance appraisal.

Research Methodology

Sample selection

Based on accessibility to the researcher only 25 enterprises are visited in Ilorin, the area of study. The distribution cut across manufacturing, wholesale and retail, trade and hotel and restaurant. These considered activity groups are the prominent in the metropolis and based on the statistic provided in Kwara state statistical year book 2000 edition they have been allocated 12, 8, and 5 respectively. Out of these only twenty operate a decentralized system. Of the twenty decentralized enterprises eighteen have goods or services transferred between divisions and twelve out of these eighteen set transferred prices based on cost.

These twelve represent the sample upon which the test is carried out result of which is generalized to the population which in this case are enterprises setting transferred price based on cost

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in Horin. Due to inadequate sample, however, generalization is only limited to organizations used for the study.

Data Collected and Procedure of Collection

Data in relation to the methods of transfer pricing generally and cost based transfer pricing specifically, and of factors that determine choice among them was collected from primary source only.

Primary data were collected through questionnaires that contain demographic and operational questions structured along the inverted funnel method. The researcher himself carried out the administration.

Method of Data analysis

Relevant Data from the field that are pertinent to the study are tabulated in a manner that they could be described and percentages computed. Some of the data generated through questionnaire administration were used for calculation of Chi square upon which the decisions to accept or reject our hypotheses are reached. Attention here is focused only on data that are pertinent to our accepting or rejecting each of our hypotheses. This is to say that those primary data that are mere notorious confounders were avoided in analysis.

Since a Yes or No question was asked, the chi-square model of goodness of fit, which tends to know whether the population of interest is distributed according to our theoretical distribution, is used. Supportive data that tend to add to the knowledge about the study were analyzed descriptively since they are not needed to test our hypothesis. Data are presented by number of organizations, because presenting them so or otherwise will have no effect on result. For hypothesis testing, data were analyzed by number of respondents.

Formular

$$\text{Chi square} = \chi^2 = \frac{\sum (O - E)^2}{E}$$

Where:

E=expected frequencies

O=observed frequencies

Table value

Table χ^2 value at 0.05 degree of freedom for the computation $n - 1$

Rule for testing hypotheses

Based on the value of the chi-square computed hypotheses are accepted or rejected accordingly. Null hypotheses are rejected and the alternative accepted if computed value is greater than critical table value and vice versa.

Presentation of data and discussion of results

Presentation of data based on responses to questionnaires distributed

Table 1 Cost bases of transfer pricing (based on question 10)

Options	Frequency	Percentage
Marginal cost	2	16.7%
Full cost	3	23.1%
Full cost plus	7	58.2%
Total	12	100%

Source: Research survey, 2002.

Full cost plus is the most adopted bases transfer pricing with 58%, then full cost with 23% and lastly marginal cost with about 18%.

Table 2 Types of profit measure for divisional performance evaluation (based on question 11)

Options	Frequency	Percentage
Variable short-run contribution	1	8.3%
Controllable contribution	2	16.7%
Divisional contribution	2	16.7%
Divisional Net profit	7	58.3%
Total	12	100%

Source: Research survey, 2002.

Divisional net profit is the most adopted divisional appraisal technique 58% score.

Table 3: Relation ship between profit measure and cost based transfer price (based on questions 10 and 11).

	Marginal cost	Full cost	Full cost plus	Total
Variable short-run contribution	1	-	-	1
Controllable contribution	1	1	-	2
Divisional contribution	-	2	-	2
Divisional Net Profit	-	-	7	7
Total	2	2	7	12

Source: Research Survey, 2002.

Table 3 shows that use of marginal short run contribution for appraisal is common to marginal cost for transfer pricing while divisional net profit is more associated with full cost plus.

Table 4: Strength of a chosen cost based transfer price is the basis for its adoption (based on question 12)

Options	Frequency	Percentage
Yes	8	33.3%
No	12	50.0%
I don't know	4	16.7%
Total	24	100%

Source: Research Survey, 2002.

The table above shows that majority, about 50%, do not believe that choice of appraisal technique is based on its strength, while 33% believe it choosing is based on its strength.

Table 5: Strength of a chosen profit measure for divisional performance evaluation technique is the basis for its adoption (based on question 13)

Options	Frequency	Percentage
Yes	6	25.0%
No	14	58.3%
I don't know	4	16.7%
Total	24	100%

Source: Research Survey, 2002.

Table 5 shows that majority, about 58%, do not believe that choice of appraisal technique is based on its strength.

Table 6: Choice of a transfer price is based on profit measure of divisional performance adopted by the organization (based on question 14)

Options	Frequency	Percentage
Yes	18	75%
No	2	8.3%
I don't know	4	16.7%
Total	24	100%

Source: Research Survey, 2002.

75% agreed about 8% disagreed and about 17% if choice of transfer price depends on divisional appraisal method adopted.

Results of data analysis

Analysis shows our computed chi-square (3.092) to be less than critical table value, which at 0.05 level of significance is (5.993). The meaning of this, based on our rule is that the null of the first hypothesis, which state that the choice of a cost based transfer price is not, related to the strength of the basis holds.

For the second hypothesis, chi-square calculated of '5.593' is less than chi-square on the table. At 0.05 level of significance, the null of the second hypothesis, which states that choice of profit measure of divisional performance, is based on its strength and superiority over other measures is accepted.

For the last hypothesis our computed chi-square (16.593) is greater than the tabulated chi-square. The meaning is that the null of the third hypothesis which states that cost based transfer price is not a function of profit measure for divisional requirement of the enterprise could be rejected, while the alternative is accepted.

Summary of our finding from the data gathered is that neither cost-based transfer price nor profit measure of divisional performance is chosen by enterprises because of consideration of them being better than others. Rather, it is shown that one variable (profit measure of divisional performance or cost based transfer price) relates to the other and choice of one has effect on choice of the other.

A further look at table 3 which tends to relate the responses presented in table 1 with those of table 2 show that transfer price adopted by enterprises relates to the type of profitability measure that is used is in the organizations. This is evidenced in the fact presented there in, which shows marginal cost transfer price to be associated with variable short run contribution measure on one extreme angle and full cost plus associated net profit measure of performance on the other extreme angle.

Conclusion

The conclusion that could be drawn from the result of this study is that, the decision to choose a transfer pricing method that is based on cost may not be a matter of its being better than other available cost-based transfer pricing methods. It could rather be a function of the requirement of individual enterprise. The result of the research further shows that profit measure of divisional profit adopted by an organization could be a requirement that a cost-based transfer-pricing model is expected to satisfy. On the other hand, profit measure model adopted too is usually not chosen because of its strength over others but because of the requirements of the organization concerned.

Based on the conclusion drawn above it is recommended that organizations should, rather than place emphasis on the search for what is said to be the best, consider what best suits its situation. As far as this research is concerned profit measure of divisional performance is the focus, however, other factors may be the case in other situations, and they must be carefully studied.

Advisably also, research should be focused, in line with above recommendation, not on one pricing system being better than the other, but on the reasons why one may be preferred as against the other. This is because this research has proven that all cost-based transfer prices have at least a use in organizations. Support for this kind of study on transfer pricing could be borrowed from Davidmann

(1996). In his article he demonstrated that transfer price across the border should reflect tax rate of countries. High transfer price should go to countries with lower tax rate and vice versa, he suggested.

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