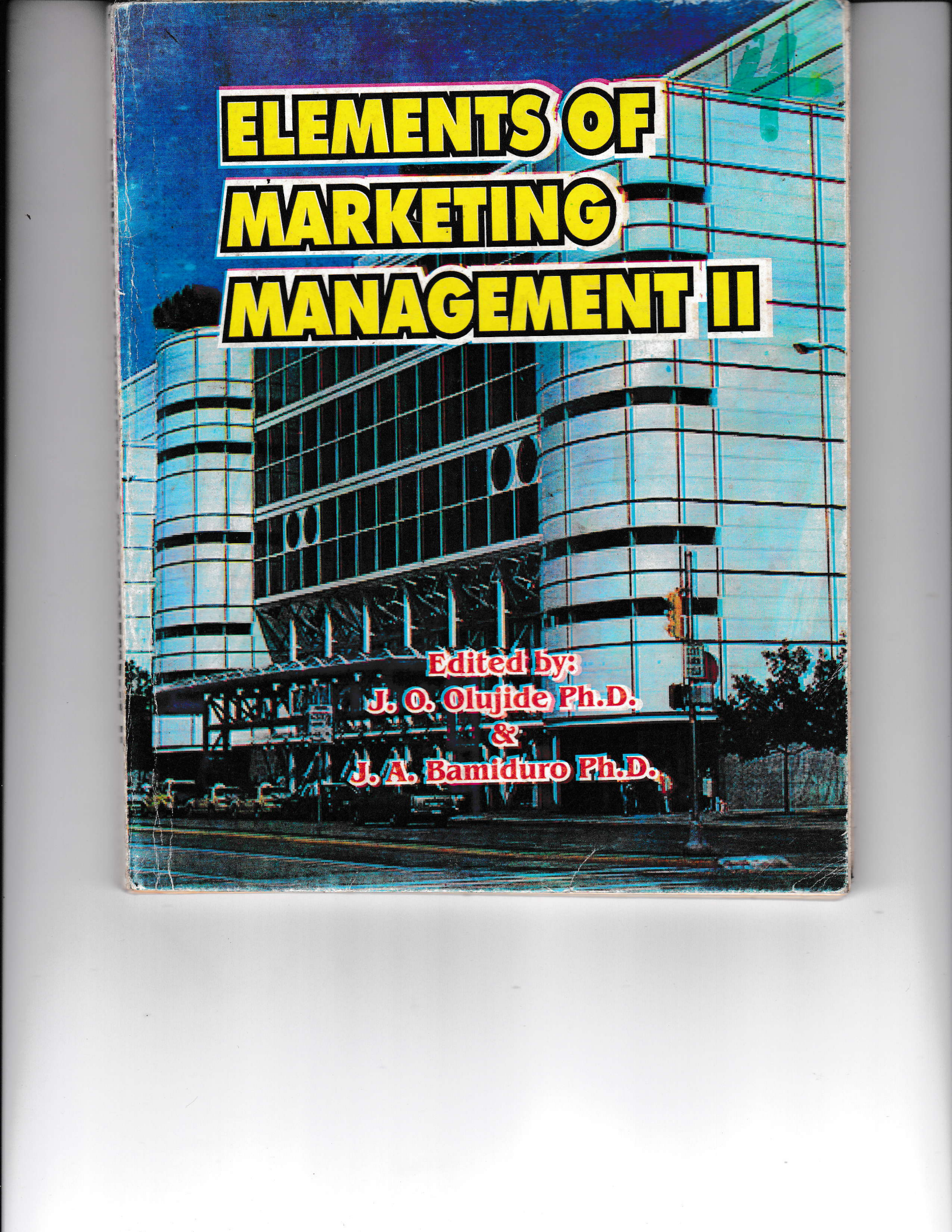




ELEMENTS OF MARKETING MANAGEMENT II

Edited by:
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&
J. A. Bamiduro Ph.D.

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Chapter**THE MARK
CLASSIFIC**

By
ISIAKA SULU
Department of Business

INTRODUCTI

Marketing
achieved usually
program to reach
plan for the attainment

In this chapter
organisation. In addition
the perspective of

In addition
various classification
applicable.

DEFINITION OF

Strategy is
Advanced Learner's
an operation in a way
a plan or policy designed
Chandler (1962) sees

"the determination
enterprise and
of resources
Anthony (1965) defines

"the process
attain these objectives
acquisition, use

Chapter Thirteen

APPLICATION OF TRANSFER PRICING IN DIVISIONALISED COMPANIES

By

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INTRODUCTION

In large corporate enterprises especially divisionalised ones, the output of one division (responsibility center) may serve as an input for another division. In this case, there is a transfer of products from one responsibility center to another at a monetary value. This is essentially an internal arrangement, which is referred to as transfer pricing.

In internal transfer of goods or service from one profit center to another, the problem of determining the value to attach to these products normally arises. This brings the need for some pricing mechanism for internal transfer of product that accurately reflect the cost and revenues of doing business. Transfer pricing is the pricing mechanism commonly use to reflect transfers between divisions.

Transfer pricing as defined by Hilton, et al. (2000) is the process of determining, reporting and acting on the imputed values of goods and services transferred from one division to another. The imputed monetary value of the goods or service transferred is called the transfer price. The price charged by a profit center for products 'sold' to another profit center in the same company can affect the profit measured for both the selling and buying divisions of the organisation. Thus, a high transfer price may lead to high profit for the selling profit center and a low profit for the buying profit center. The reverse will be the case when the transfer price is low. This implies that transfer pricing can either positively or negatively affect the incentives of autonomous division managers as they decide whether or not to make a transfer of a product. It should be pointed out that in the real sense, transfer pricing may not affect the overall total profit of the entire organization except where it affects divisional behaviours.

The focus of this paper is on the use of transfer pricing in profit investment

centers. It examines the followings: the uses of transfer pricing; criteria for transfer pricing; methods of transfer pricing; the problems of transfer pricing; and possible solutions to mitigate the problems identified.

The paper is divided into five sections. Section one presents the uses of transfer pricing; section two highlights the criteria for transfer pricing; section three discusses the transfer pricing methods and their various applications in practice; section four summarizes the general problems associated with transfer practice; section four summarizes the general problems associated with transfer pricing; and lastly, section five presents suggestions for improvements on the applications of transfer pricing.

THE USES OF TRANSFER PRICING:

Transfer pricing technique in profit centers can be very useful in the following ways: Primarily, transfer pricing is used for computing the monetary value that will be attached to goods or services that are exchanged between divisions. Without the transfer pricing system, there can be no suitable way of determining a suitable value for products 'sold' by one profit center to another. Transfer pricing can also be used in a decentralized organisation for the appraisal of the performance of separate divisions. Profit centers involved in the internal transfer of goods or services. Transfer price based on market price will best serve the purpose of divisional performance evaluation. Using this method of transfer pricing, the profitability of the buying and selling profit centers can be objectively measured and evaluated. Further more, transfer pricing can be used for the efficient management of a large enterprise through decentralization. Once responsibility centers are established, goods and services transfer between these units are priced, this helps separate and pinpoint responsibility for different aspects of the firm's functions. In other words, to some extent, transfer-pricing mechanism enhances decentralization and the benefit of decentralization of efficient management can be reaped. Also, transfer pricing can be used to motivate and enhance the performance of division managers. In a decentralized organisation, the managers of profit centers and investment centers often have considerable autonomy in deciding whether to accept or reject orders and whether to buy from inside the organization or from outside. According to Hillon, et al, (2000), the one of goals in setting transfer prices is to establish incentives for autonomous division managers to make decisions that are in the best interest of the company. Lastly, transfer pricing can improve communication problems in an enterprise. Conflicts can best be resolved through confrontation, usually in the form of negotiations. As divisions negotiate for a transfer price, there will be interactions among divisional managers and their differences can be eliminated. Thus, transfer pricing can help in conflict resolution in an organization.

CRITERIA FOR TRANSFER PRICING:

There are certain criteria or rules which all transfer pricing methods must meet. These are (i) Goal congruence (ii) Motivation (iii) Autonomy and (iv)

Performance evaluation. According to Polimeni, et al. (1991), the above criteria are interrelated and should be used to evaluate the transfer pricing methods being used by profit or investment centers. These criteria are also referred to as objectives of transfer pricing. They are discussed below.

GOAL CONGRUENCE:

Goal congruence is the pursuance of a division's own goals, which are in agreement with the overall goals of the organization. A good transfer pricing policy should encourage each divisional manager to take decisions that are not only beneficial to them but also in consonant with the corporate objectives of the enterprise as a whole. In other words, a transfer pricing system should minimise to the barest minimum the tendency towards sub-optimality. Sub-optimality is the maximization of the divisional goals to the detriment of the overall corporate goal of the company.

PERFORMANCE EVALUATION:

A good transfer pricing method should be such that would enable central management to effectively determine the contribution of each of the divisions towards corporate profit. Regardless of whether the buying and selling responsibility centers are cost, profit or investment centers, the transfer prices should not adversely affect the "fairness" of the performance evaluation process and the incentive plans that are based thereon (Polimeni, et al. 1991).

MOTIVATION:

Motivation, being a phenomenon that "drives" individuals to accomplish goals can be enhanced by a good transfer pricing. Therefore, an acceptable transfer price should not interfere with the process where-in, the buying profit center manager rationally strives to minimize his cost and the selling profit center manager rationally strives to maximize his revenues.

AUTONOMY:

The transfer pricing policy chosen should encourage the selling and buying division to act independently without any undue control from the central management. Each profit center should be free to satisfy his own needs whether internally or externally at the best possible price. The transfer pricing is required to

preserve the autonomy of the divisions so that the full benefit of decentralization can be achieved. Sollenberger, and Schneider, (1996) opined that the above four criteria discussed should be prioritized when formulating transfer pricing policies. This is so because different situations will demand different transfer policies.

TRANSFER PRICING METHODS:

Transfer pricing methods are the various modalities for arriving at transfer price. There are many transfer pricing methods that can be used for interdivisional transfer. The most common transfer pricing methods are: (i) cost based methods (ii) market based method (iii) Negotiated transfer price and (iv) Dual-pricing method. These methods of transfer pricing are discussed below.

Cost Based Transfer Pricing Method:

Using this method, the selling profit center sells to the buying profit center either at the actual cost it has incurred or cost plus a mark-up or even at standard cost. The cost based transfer price is the most common method of transfer price in the practice (Tang, 1992) and the various versions of cost based transfer pricing include:

Variable cost:

With this method only variable production costs are transferred to the buying division. This price is made up of direct materials cost, direct labour cost and variable overheads. This method is appropriate when there is excess capacity in the selling or buying division.

Full Cost:

This entails that all product absorption costs are transferred to the buying division; thereby enabling the selling division to recover all production costs including fixed overheads as well as selling and administrative costs. Full cost transfer price encourages the transfer of inefficiency from the selling division to the buying division by including fixed costs in the price of the products transferred.

Standard cost:

This transfer price is based on pre-determined cost rather than actual cost in order to prevent the transfer of inefficiency of the selling division to the buying division. The standard cost could be standard full cost or standard variable cost. If a cost-based transfer method must be used, the standard cost /cost plus is the best option.

Cost plus mark-up:

This transfer pricing method adds a percentage of profit to either the full cost or variable cost in order to provide a profit to the selling division. This method is usually used when there is no competitive market for the intermediate product. But there is the danger that the receiving division may restrict its output below that of the optimal output level for the company as a whole. Generally, the cost based methods of transfer pricing can be useful where there is no market price. At times it can lead to optimal decision i.e. goal congruence especially where the variable cost version is used provided there is no capacity constraint in the selling division. Also, cost based transfer prices can be easily obtained from the cost books. One of the drawbacks of cost-based methods of pricing intra division transfer is the fact that divisions are treated like cost centers rather than as profit or investment centers. Also, this method does not enhance the objective measurement of the performance of the selling and buying division managers. Lastly, decisions based on full cost may lead to dysfunctional decision-making behaviours. In summary, it can be said that the cost based transfer price does not meet adequately the four criteria for Transfer pricing.

MARKET BASED TRANSFER PRICING METHOD:

Market price is a price set between independent buyers and sellers. This is the price reigning in a perfect market. Where the market price is adopted as the transfer price, both the buying and selling profit centers would be operating at arm's-length, as if they are not in the same organization. The basic requirements for market price include: the existence of market for the goods or service being transferred; and accessibility by both the buyer and selling profit center to other sellers and buyers for the same product (that the market should be perfect). This method of transfer pricing has the following advantages: It ensures goal congruence as divisional managers using this method act not only in the interest of their divisions but also in the interest of the whole organization as a whole. This can be true where there is no excess capacity in selling profit centre. It also enhances divisional autonomy as divisional managers are free to buy from outside source if they feel it is cheaper to do so. Also, the criterion of motivation of divisional managers is also met by the market price as the buying divisional manager is encouraged to minimize his cost and the selling divisional manager rationally strives to maximize his revenues (Polimeni, et al. 1991). The market-based transfer price also enhances the objective measurement of performance of the selling and buying divisional managers as market prices are objective and verifiable. Lastly, the question of transfer of inefficiency does not arise, as the fixed cost of the selling division will not be transferred.

Generally, market price insets more of the transfer pricing criteria than any single method of transfer pricing.

Despite the benefits of market price, it has the following limitations: Non availability of market especially for intermediate products; lack of appropriate and fair market price; lack of perfect information about the market price; and lastly, market price may serve as disincentive to the use of any spare capacity by the selling division, thereby leading to dysfunctional decisions.

NEGOTIATED TRANSFER PRICING METHOD

Negotiated transfer prices has been suggested as a result of difficulties in establishing a sound transfer pricing method. Under this method, this selling and the purchasing division agree in advance to use a mutual, acceptable transfer price. Negotiated transfer prices are most appropriate in situations where there is no market for intermediate product or where imperfect market exists. This method is often suggested as a compromise between the market price at the upper limit and some measure of cost at the lower limit (Benke, and Edwards ,1980)

The advantages of negotiated prices include: a stronger motivational impact on the divisional managers involved in the internal transaction; it has been identified by Watson, and Baumler (1975) as a means by which goal congruence can be achieved; performance evaluation of divisional managers can be enhanced provided the negotiation is fair; it can lead to some measure of divisional autonomy; and lastly, there is less dispute on the transfer prices used since disagreements would have to be sorted out.

The drawbacks of this method are: too much management time can be spent on negotiations; performance evaluation may not be based on profitability but rather on the ability of divisional managers to negotiate; it can lead to conflicts between divisions if it is not properly handled; and lastly it can lead to sub-optimal decisions.

DUAL TRANSFER PRICING SYSTEM

It may not be possible to have a single transfer price for intra company transfers that meet all the four criteria for transfer pricing. Therefore, two transfer prices may be used in a single internal transfer transaction.

According to Polimeni, et al. (1991) in a dual price situation, the buying profit center is charged the synthetic market price, while the selling profit centre is given a credit for either standard variable or full cost plus a normal mark-up. Synthetic price = variables cost + opportunity cost.

The objective of dual transfer pricing is to provide the selling profit center a profit but charge the buying profit centre with standard variable cost plus opportunity cost. Opportunity cost will arise if the selling profit center has no spare capacity.

In assessing the dual transfer price, it has the advantage of enhancing the fair evaluation of the performance of both selling and buying profit centers. It also encourages behaviour that will benefit the firm as a whole since the buying division is provided with only cost information and at the same time the selling division is allowed to show a profit.

The danger of dual transfer pricing is that there are usually top management interferences which hinder the autonomy criterion for transfer pricing. This is manifested in the monitoring, recording and keeping track of intra company dealings (Sollenberger, and Schnedar, 1996)

A HYPOTHETICAL CASE OF TRANSFER PRICING IN A DIVISIONALISED COMPANY

The principle and concept of transfer pricing discuss earlier on will now be applied in a hypothetical situation as can be found in practice.

OSISIONI MANUFACTURING PLC

Osisioni Manufacturing plc has two divisions which are profit centers, X and Y. Profit center X produces a product- 'ekara' and Profit center Y packages and distributes the products at a selling price of N30.00 per unit. Profit Center X produces 200,000 units of 'ekara' which can be transferred to profit center Y. But if division Y did not buy them then all the units can be sold in an intermediate market for Ni 1.000 per unit. Hence, there is no spare capacity in division X.

The following are the expected (standard) revenue and costs:

	Division X	Division Y
Sales (Units)	200,000	200,000
Direct materials cost per unit	N2.00	N 1.00
Direct labour cost per unit	N1.20	N2.00
Variable overheads cost per unit	N0.80	N3.00
Fixed cost	N600,000	N550,000
Outside market price per unit	N 11.00	N23.00
Mark-up percentage	40%	40%
Negotiated price per unit	N10.00	
Mark-up % for dual pricing	40%	

DETERMINATION OF TRANSFER PRICE IN OSISIONI plc

Each of the transfer pricing methods discussed earlier on will be applied from the perspective of the buying profit center, the selling profit center, and the company as a whole bearing in mind the four criteria for transfer pricing.

The contribution approach is employed in determining the effect of each of the following transfer prices on the profitability of the divisions and the company as a whole:

- (1) Standard cost-based transfer pricing methods:
 - (a) variable cost (b) Full cost (c) Cost plus mark-up
- (2) Market Price (3) Negotiated price (4) Dual transfer price

(1) Variable Cost transfer Price:

The transfer price set at variable cost of division X will amount to N4.00 per unit. Division X variable cost per unit = N2.00 + N1.20 + .80 = N4.00

Profit Statement

	Division <u>X</u>	Division <u>Y</u>	Company as <u>a whole</u>
Selling price per unit	-	N23.00	N23.00
Transfer price unit	N4.00	(4.00)	
Variable cost	(4.00)	(7.00)	(11.00)
Contribution per unit	—	N12.00	N12.00
Units sold	x200,00	x200,00	x200,00
Total Contribution	—	N2,400,000	N2,400,000
Fixed Cost	(N600,000)	(N550,000)	(N1,150,000)
Net Profit (Loss)	(N600,000)	N1,250,000	N1,250,000

Comments

The transfer price at variable cost of N4.00 per unit will result in goal congruence since this sends signal to division Y to buy from the division X at a cheaper price of N4.00 per unit as compared to external price of N11.00. More so, the company as a whole will be making a contribution of N2,400,000.

Motivation and the performance evaluation criteria will suffer under this transfer price as profit center X will not report any profit.

Also, if division X manager is forced against his will to sell to the division Y then autonomy will be eroded.

(2) Full cost transfer Price:

Here the transfer price is at division X absorption cost of N7.00 per unit (N4.00=N3.00)*. The cost is made up of variable costs and fixed cost.

Profit Statement

	Division X	Division Y	Company as a whole
Selling Price Per unit		N23.00	N23.00
Transfer Price	N7.00	(7.00)	—
Variable Cost	(4.00)	(7.00)	(14.00)
Contribution Per Unit	N3.00	N9.00	N12.00
Units Sold:	<u>x200,000</u>	<u>x200,000</u>	<u>x200,000</u>
Total Contribution	N600,000	N1,800,000	N2,400,000
Fixed Costs	(600,000)	(550,000)	(1,150,000)
Profit	<u>Nill</u>	<u>N1,250,000</u>	<u>N1,250,000</u>

Notes: Variable Cost Per Unit: Division X = N4.00 (N2.00 + N1.20 + N.80)
Division Y= N10.00 (N1.00 + N5.00 +N4.00)

Transfer Price of Division X product = N4.00 + N3.00
= N7.00

Comments

A transfer price set at full cost equal to N7.00 per unit will lead to goal congruence as profit center Y will be encouraged to buy internally from profit center X instead of buying at a costly price of N11.00 from outside, per unit. As a result of this transfer price, the company as a whole is making a total contribution of N2,400,000 and a profit of N1,250,000.

However, since profit center X only managed to break-even while profit center Y is making a profit of N1,250,000, the motivation and performance evaluation criteria will suffer. If the selling profit center is compelled to sell to Division Y then the autonomy criterion will not also be satisfied by full cost transfer price.

(3) **Full Cost Plus Mark-up transfer Price.**

Using the full cost plus mark up price, the transfer price will be set at total absorption cost plus normal profit mark-up of 40%. Hence, the price at which

Division X will sell to Division Y is N9.80 (N7 x 1.40)

Profit Statement

	Division X	Division Y	Company as a whole
Selling Price Per Unit		N23.00	N23.00
Transfer price per unit	N9.80 —	(9.80)	—
Variable cost	(4.00)	(7.00)	(11.00)
Contribution per unit	N5.80	N6.20	12.00
Units sold	x200,000	x 200,000	x 200,000
Total Contribution	N1,160,000	N1,240,000	N2,400,000
Fixed Costs	(600,000)	(550,000)	(1,150,000)
Profit	N560,000	N690,000	N1,250,000

Comments

Full cost plus mark-up transfer price can at times, to some extent, satisfy the criteria of autonomy, goal congruence, motivation and performance evaluation especially if there is no market price. This transfer price is much fairer than the variable cost and full cost transfer prices as the two divisions X and Y posted a contribution of N1,160,000, N1,240,000 and profit of N560,000, N690,000 respectively.

However, since the transfer price of N9.80 is lower than the market price of N11.00 it may not be able to motivate division X manager enough to sell to division Y as he is losing N2.00 per unit. If division X manager is forced to sell internally, then the autonomy criterion will be hampered.

(4) Market transfer Price:

Adopting the market price for the internal transfer of goods the transfer price will be set at N11.00 per unit. This being the price at which Division X can sell its product to an outside buyer and 22 the price at which division Y can buy the same product from an external supplier.

Profit Statement

	Division X	Division Y	Company as a whole
Selling Price per unit		N23.00	N23.00
Transfer Price	N11.00	(10.00)	
Variable Cost	(4.00)	(7.00)	(12.00)
Contribution per unit	N7.00	N5.00	N12.00
Units sold	<u>x200,000</u>	<u>x200,000</u>	<u>x200,000</u>
Total contribution	N1,400,000	N1,000,000	N2,400,000
Fixed cost	(600,000)	(550,000)	(1,540,000)
Profit	<u>N800,000</u>	<u>N450,000</u>	<u>N1,250,000</u>
Comments			

It can be seen here that with the market price, Division X is able to make a maximum contribution of N1,400,000 and profit of N800,000 which is highly motivating. Market price thus does encourage motivation, leads to goal congruence, enhances objective performance evaluation and ensures divisional autonomy of the divisions. However, division Y may not be satisfied with the market price of N11.00 per unit and so may request that division X manager reduce the price since selling expenses will not be incurred by selling to him.

(5) Negotiated Transfer Price in this case both the buying and selling divisions have agreed on a transfer price at N10.00 per unit.

Profit Statement

	Division X	Division Y	Company as a whole
Selling Price per unit		N23.00	N23.00
Transfer price per unit	N10.00	(10.00)	
Variable cost	(4.00)	(7.00)	(11.00)
Contribution per unit	N6.00	N 6.00	N12.00
Units sold	x200,000	x200,000	x200,000
Total Contribution	N1,200,000	N1,200,000	N 2,400,000
Fixed Cost	(600,000)	(550,000)	(1,150,000)
Profit	<u>N600,000</u>	<u>N650,000</u>	<u>N1,250,000</u>

Comments:

In this case, the total contribution of the company is fairly distributed between the selling and buying divisions as they posted a contribution of N1,200,000 and N1,200,000 respectively. Therefore, the negotiated transfer price of N10.00 appears to be satisfying the criteria of motivation, performance evaluation, goal congruence and autonomy. Negotiated transfer price is a compromise between the full cost plus mark-up price and the market price. However, the time involved in negotiation can be much, which may divert attention from other vital management issues.

(6) Dual Transfer Pricing

Here two prices are used for transfer of goods from division X to Y. Division X is credited with full cost plus profit at N9.80 and division Y is charged with a synthetic market price of N8.00 per (variable cost + opportunity cost).

Profit Statement

	Div. X	Div Y	Company as a whole
Selling Price Per unit	-	N23.00	N 23.00
Transfer prize per unit	N9.80	(8.00)	
Variable cost	(4.00)	(7.00)	11.00
Contribution Per unit	N 5.80	N 8.00	N 12.00
Unit Sold	<u>X200,000</u>	<u>X200,000</u>	<u>X200,000</u>
Total contribution	N1,160,000	N1,600,000	N2,400,000
Fixed cost	(600,000)	(550,000)	(1,150,000)
Profit	N 560,000	N 1,050,000	N 1,250,000

Note: Opportunity cost = market price minus - full cost per unit in Division X
 $= N11.00 - N7.00 = N4.00$

Synthetic price = Variable cost + Opportunity cost = N4 + N4N8.00

Comments:

From the profit statement above it will be discovered that total profit for the company as a whole (N1 250,000) is not equal to the sum of the profits of division X and Y (N1,610,000) as in other transfer pricing methods. This is due to dual prices used. The difference (N360,000) can be eliminated in the cost books.

Dual transfer pricing can be beneficial to the company as a whole, thus leading to goal congruence. Here division X made a reasonable contribution of N1

160,000 and reasonable profit of N560,000, hence it satisfies the motivation and performance evaluation criteria.

Autonomy can be threatened as the management has to constantly intervene in the transfer system.

GENERAL PROBLEMS OF TRANSFER PRICING

There are certain problems which transfer pricing can create in an organization if it is not properly handled.

Firstly, the basic problem is that no method of transfer pricing can satisfactorily and simultaneously meet the four criteria of performance evaluation, goal congruence, autonomy and motivation.

Secondly, the practice of basing the evaluation of performance solely on profit made by profit centers may not always be the best. This may encourage some unethical practices by divisional managers in order to maximize their profits. There should be other forms of performance evaluation.

Thirdly, there is the problem of conflicts that may ensue among the divisions that make up the organization when an agreement cannot be reached despite several negotiations and renegotiations of a transfer price. Transfer pricing in a company may therefore result to behavioural contest between one selling and buying profit centers if it is not properly managed.

Fourthly, the time spent on negotiations and renegotiation by divisional managements can be too long and may divert the attention of the management from the real important management problems.

Lastly, transfer pricing if not carefully managed can lead to dysfunctional behavioural problems in the company. Divisional managers can abuse the autonomy granted them by the top management and thus get involved in high competition and pursue divisional goals at the expense of the overall corporate goal of the company. The situation is that every divisional manager wants to be free from control but this cannot be possible.

SUGGESTIONS FOR IMPROVEMENT OF TRANSFER PRICING.

The following measures can be taken to improve transfer pricing problems in an organisation.

One, to address the problems of conflicts, which transfer pricing, may bring, companies operating such system should put in place an impartial arbitration board to resolve such conflicts. The board should be made up of one or more top level managers and representative of divisions that are not involved or have no interest in the internal transfer case.

Two, to prevent sub-optimization and to remedy a situation where two

divisions cannot agree on a transfer price, there should be arbitrary transfer pricing system prescribed by the central management. The divisional managers involved in the transfer case should be made to see reason why they should accept the top management prescribed transfer price.

Three, divisional reported profit should not be the only yardstick for measuring divisional performance. The efficiency and effectiveness of divisional managers in spending can also be a basis for their performance measurement, this can be reflected in controllable cost variance from the standard.

Four, to further help to reduce tension which transfer pricing system may generate, an optimal transfer pricing system which ensures benefits for the selling and buying divisions and the company as a whole can be put in place. It will also be mentioned that market price, where available, can be very useful and can produce a good result.

Lastly, it is suggested that each company should determine what it wants from a particular transfer pricing method. The criteria for transfer pricing should be prioritised by the central management as this will help them to select the best transfer pricing method that suites their organization. Most of the time, the best transfer pricing method is that which benefits the company and creates minimum tension.

CONCLUSION

All the Transfer pricing methods examined in this paper are fraught with one problem or the other. Hence no single transfer price can meet all the transfer pricing criteria simultaneously. However, market price where it exists for intermediate goods and the market is perfect came close to meeting all the criteria. Where there is no market or there is imperfect market for intermediate product, the best transfer price especially where there is no capacity constraint, is the marginal cost price.

Notwithstanding the problems of transfer pricing, its importance cannot be over emphasised, as without some form of transfer pricing, the whole structure of inter-divisional performance evaluation and analysis and control would not be stable. The limitations associated with transfer pricing should be recognised and any results obtained should be interpreted in the light of those limitations.

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