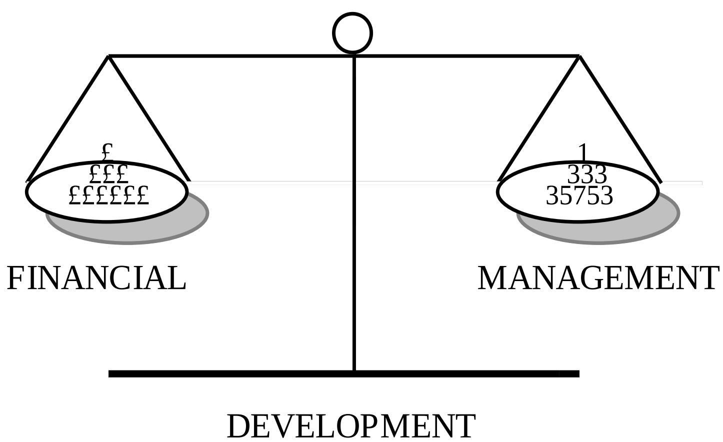
FINANCIAL MANAGEMENT DEVELOPMENT

Decision Making

Management Accounting

NO 315

TRANSFER PRICING



ONE OF A SERIES OF GUIDES FOR

FINANCIAL MANAGEMENT DEVELOPMENT

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

TRANSFER PRICING

The Problem

In any decentralised but interdependent organisation there are problems agreeing a transfer price for intergroup trading. By allowing parts of the organisation autonomy over their own decisions the organisation allows them freedom to make decisions which are not in the best interests of the organisation as a whole. By rewarding performance based on one criterion the organisation causes managers to lose sight of the other goals which the organisation wishes to strive towards.

There should be three objectives for any system of transfer pricing.

The system should:

1. Encourage managers to make decisions which are conducive to the long term health of the whole organisation.

2. Assist senior management to assess the performance of the units within the organisation.

3. Promote autonomy within the separate units of the organisation to allow informed decision making to be made at local level.

In addition the system is often used to assist with measuring the performance of the managers of units within the organisation.

It is unlikely that any system of transfer pricing can satisfactorily achieve even the three main objectives simultaneously.

Three key points must be made:

1. The transfer price should never be used to set selling prices.

2. Whatever price is agreed will not affect profit for the entity.

3. Performance can be measured against the agreed price whatever it is. The amount of profit cannot be compared across entities unless constraints are allowed for.

The three main methods of transfer pricing in common use are:
1. Market Price
2. Cost
3. Cost Plus:
    a. a variable percentage or
    b. a lump sum or
    c. opportunity cost

Some of the advantages and disadvantages of each are set out below.

1. **Market Price**

   Where divisions within an organisation are not mutually dependent upon each other and where there is a readily perceivable market which does not suffer from unusual pricing for competitive purposes, transfers at market price are an extremely effective method of assisting unit managers make decisions which are in the best interests of the organisation as a whole.

   An example is the central treasury function. The prices paid for surplus funds or for borrowing from the treasury should be at market price with units being encouraged to use the central treasury to assist the organisation maximise profit. However, even in this, near perfect, market the absence of consideration of the goals of the organisation as a whole can cause demotivation for managers within the organisation when “special rates” are seen externally.

   Unfortunately the conditions set out above are rarely met in practice. There are few perfect markets and frequently the internal trading involves commodities which are unique to either supplier or producer. Fluctuation in supply and demand can cause market prices to change when the long term economics of the situation are stable. Frequently the internal negotiation process is hindered by the dependence of one of the parties involved on the other and the essential process of arbitration is rarely evoked because managers will shirk from the admission that they cannot agree.

2. **Cost**

   Transfers at cost normally avoid some of the inefficiencies caused by transfers at market price, but can be extremely demotivating for the producing unit. In particular there is little incentive to reduce cost and no “profit” to identify with.

   There is also the problem of identifying “cost”. Should it include variable costs alone or should there be a contribution towards fixed costs? If the latter, should this be based on absorption at an assumed production rate or based on actual production?

   Fixed cost absorption based on actual production levels will cause the transfer price to fluctuate inversely with the degree of activity of the producer. This is unlikely to be acceptable to the purchaser.

3. **<u>Cost Plus</u>**

   The problem lies with the calculation of the "plus".

   a. A Variable Percentage

      This has some merit is giving a return on the costs incurred but has the unfortunate side effect of motivating the producer to incur high costs. Any cost savings are unlikely to be implemented as they will lower the amount of the "plus".

   b. A Lump Sum

      This fixes the profit element and can be helpful in reducing variability in the price used. However it normally causes managers to concentrate on negotiation of the "lump sum" rather than the cost. Since the lump sum is not relevant for any decisions involving the health of the organisation in total this is not the best use of management time.

   c. Opportunity Cost

      Opportunity cost is the benefit lost by not adopting the next best alternative. In many cases this will cause the transfer price to revert to market price since the opportunity cost will be the profit foregone by not selling the product externally. This method has advantages in that it forces management to consider the alternatives involved and therefore the possibilities for utilising spare capacity or disposing of idle plant. However it can result in too much emphasis on non-core activities and time spent on reviewing alternatives which although feasible are not in the interests of the organisation as a whole.

When considering transfer prices management should:

1. Seriously consider dual pricing. There is no theoretical reason why the producing department cannot receive a profit element which is not charged to the receiving department but is adjusted centrally.

2. Consider the objectives of the system.

3. Decide if the benefits to be gained by removing the risk of decisions being made which are not in the interests of the whole organisation outweigh the costs involved by reducing autonomy in decision making.

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website: **FinancialManagementDevelopment.com** including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).

