① Simple Div. cy = FCFE ② Multistage Cu's

Div. cap = FCFE

4 Dividend policy

Dividend decisions determine the amount of and the way that a company's profits are distributed to its shareholders.

4.1 Is dividend policy irrelevant?

MoM THEORY (FP)

Shareholders who hold the shares of a company are entitled to a portion of the income that the company generates and of the assets that it owns. The dividend policy of a company refers to the decision taken by the management of the company with regard to how much of a company's earnings will be distributed to shareholders and how much will be retained within the firm.

In reaching this decision, the management of the company should try, as in all financial management decisions, to maximise the wealth of the company's shareholders. However, there is little agreement as to the impact of dividend policy on shareholder wealth, and the interaction between dividend payments, financing decisions and the value of a company has been the subject of theoretical analysis and empirical investigation.

At one end of the debate, Modigliani and Miller have maintained that the dividend policy of a corporation is irrelevant because the value of a company is not affected by its financial policy.

Suppose a company pays dividends without changing investment and financing policies. The money that the company will pay as dividends has to come from somewhere else. If the company maintains the amount of debt (does not borrow to pay the dividend), the company needs to issue new shares to finance the dividend. The new shareholders will pay only what the shares are worth, and the old shareholders will receive the money paid by the new shareholders as dividends. After the dividend is paid, the value per share should be equal to the old price minus the dividend paid by the new shareholders. The value of the firm remains the same, but money changed hands from new to old shareholders. Dividend policies are therefore irrelevant.

4.2 Ways of paying dividend

Companies have many ways of returning money to the shareholders. The main ones are:

(a) Cash dividends. This the most common way of paying dividends by corporations. These dividends are paid in cash, usually quarterly. Companies can declare both regular and 'extra' dividends. Regular dividends usually remain unchanged in the future, but 'extraordinary' or 'special' dividends are unlikely to be repeated.

(b) Dividends in the form of shares. These are paid instead of cash dividends by allocating shares of equivalent value to existing shareholders. Shareholders receive new shares in the corporation as a form of a dividend. Like a 'share split', the number of shares increases, but no cash changes hands.

(c) Share repurchases. This is an alternative way to distribute cash to shareholders. The firm buys back its own shares. This can be done on the open market, by tender offer or by buying stock from major shareholders.

A major difference between dividends and share repurchases is their tax treatment. Cash dividends are taxed as income but share repurchases are subject to capital gains tax only if a capital gain has been realised.

Both cash and stock dividends reduce the value per share.

4.3 Dividend capacity (Simple) 1 6/13

The dividend capacity of a corporation determines how much of a company's income can be paid out as dividend. The dividend capacity of the company is also known as the free cash flow to equity (FCFE).

The estimation of dividend capacity of a firm is dealt with in Chapter 4. Here we simply give the definition of the FCFE.

FCFE = Net income (EBIT – net interest – tax paid)

add	Depreciation
less	Total net investment (change in capital investment + change in working capital)
add	Net debt issued (new borrowings less any repayments)
add	Net equity issued (new issues less any equity repurchases)

The FCFE represents the cash available to the company which could be paid out to shareholders as dividends.

The FCFE is usually not the same as actual dividends in a given year because normally the management of a company deliberately smoothes dividend payments over time. There are also rules which restrict the payment of distributable profits only as dividends.

4.4 Theories of dividend policy

The Modigliani and Miller argument that dividend policy is irrelevant should have led to a random pattern of dividend payments. In practice, dividend payments tend to be smoothed over time. In this section we review some of the reasons that have been put forward as explanation for the payment of dividends.

4.4.1 The residual theory of dividend payments

According to this theory, firms will only pay dividends if all the profitable investment opportunities have been funded. This theory assumes that internal funds are the cheapest source of financing, and the company will resort to external financing only if the available internal funds, current and retained earnings have been exhausted.

4.4.2 Target payout ratio

According to the target payout theory, companies pay out as dividends a fixed proportion of their earnings. Firms have long-run target dividend payout ratios.

(a) Mature companies with stable earnings usually have a higher dividend payout ratio than growth companies.

(b) Managers focus more on dividend changes than absolute amounts.

(c) Transitory changes in earnings usually do not affect dividend payouts.

(d) Only long-term shifts in earnings can be followed by changes in dividends.

(e) Managers are reluctant to change dividend payout ratios due to the potential signals that such changes may send to the markets (see below).

4.4.3 Dividends as signals

Dividends can be used to convey good (or bad) information. A firm that increases its dividend payout ratio may be signalling that it expects future cash flows to increase, as this ratio tends to remain steady over time. Bad firms can also increase dividends to try to convince the markets that they too are expecting increased future cash flows. However, this increase may be unsustainable if the promised increases do not occur and the inevitable reduction in dividend payout ratio will mean heavy penalties from the markets.

4.4.4 Agency theory

Dividend payments can be an instrument to monitor managers. When firms pay dividends they often need to subsequently go to the capital markets to fund the projects. When firms go to the financial markets they will be scrutinised by different market participants. For instance, investors will require an analysis of the creditworthiness of the firm. Companies often announce dividend payments in conjunction with trying to raise new capital.

4.4.5 Dividends and taxes

A final theory explaining dividend payments is based on the presence of different corporate and personal taxes on one hand and of different income and capital gains taxes on the other. Modigliani and Miller assume that there are no personal taxes. Taxes on dividends (ordinary income) are higher than taxes on capital gains. Thus, under the presence of personal taxes, companies should not pay dividends because investors require a higher return to companies that pay dividends. If payments are to be made to shareholders, the company should opt for other alternatives, such as share repurchases. This is true if taxes on dividend income are higher than taxes on capital gains.

However, different investors have different tax rates. High tax-rate individuals will prefer the firm to invest more, whereas low tax individuals may prefer that the firm does not invest and instead pays dividends. Investors try to select companies with dividend policies that approximate their requirements.

Dividend capacity and dividend policy were also covered in Chapter 1, Section 4 and are considered further in Chapter 4.

June 2013 Question 4 asked about the dividend policies of a company and its potential investments.

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10 Dividend capacity → Multinational 12/10, 6/13

The dividend capacity of a multinational company depends on its after-tax profits, investment plans and foreign dividends.

There was a six-mark section in June 2013 Question 4 asking students to calculate the level of increase in dividends from overseas investments that would raise the investing company's dividend capacity by 10%.

We have introduced the concept of the dividend capacity of an organisation above. Here we extend the treatment to the case of a multinational company and highlight the role of special factors, such as remittances from subsidiaries and the timing of payments.

The potential dividend that can be paid, ie the dividend capacity of the firm, can be estimated as follows.

FORMAT

Operating cash flows from domestic operations	plus
Depreciation	plus
Dividends from foreign affiliates and subsidiaries	plus
Net equity issuance (ie new issues net of repurchases)	plus
Net debt issuance (ie new borrowing net of repayment)	less
Interest payments on debt, less any interest income	less
Taxes	less
Net investment in non-current assets (net of asset sales)	less

Net investment in working capital, inclusive of cash and marketable securities.

Dividend capacity, or FCFE, represents dividends that could be paid to shareholders. This is usually not the same as actual dividends in a given year because normally the management of a company deliberately smoothes dividend payments across time. In the rest of this section we look in greater detail at three of the factors: total net investment, share repurchases and foreign dividends.

> You should know how the various parts of the FCFE equation affect dividend capacity.

10.1 Effect of investment plans

Total net investment is the single most important factor in determining dividend payouts to the shareholders. According to pecking order hypothesis, funding investments with internal funds is the first choice of management, followed by borrowing or share issues. Consequently, fast-growing companies would be associated with low dividend distributions.

10.2 Effect of share repurchases

A company that opts to repurchase its shares transfers funds from the company to the shareholders. The repurchase is financed from the firm's distributable reserves. The effect of a share repurchase is to increase the earnings per share, as the number of issued shares is reduced. The evidence suggests that markets react favourably to announcements of share repurchases. The rationale for the positive reaction is that when there are no investment opportunities then it is preferable for the excess cash to be returned to shareholders rather than to be retained within the company.

Share repurchases as a method of distribution represented a larger amount than dividends in the US. The reason for this is the more favourable tax treatment of share repurchases, which is subject to capital gains tax, whereas dividend payments are subject to income tax which is higher.

10.3 Dividends from overseas operations

Corporations paying dividends to common shareholders could, for example, fund these payments by triggering repatriations. Repatriations help parent companies meet their financing needs as larger dividends to external shareholders are associated with larger dividend repatriations inside the firm, and highly levered parent companies with profitable domestic investment opportunities draw more heavily on the resources of their foreign affiliates. In fact, dividend repatriations represent sizeable financial flows for the US companies. For example in 1999 US corporations listed in Compustat paid $198 billion in dividends to common shareholders and foreign affiliates of US multinational firms repatriated $97 billion to the US as dividends.

The importance of repatriated dividends is not limited to quoted companies, which it may be argued face pressure from the markets to distribute dividends to shareholders. Even private companies rely heavily on their overseas subsidiaries to finance dividend distributions. The evidence suggests that this is happening even when dividend repatriation is not tax efficient.

11 Dividend repatriation policies (Do not ignore)

The amount of dividends subsidiaries pay to the parent company depend on the parent company's dividend policies, financing needs, taxation and managerial control.

The choice of whether to repatriate earnings from a foreign subsidiary is one of the most important decisions in multinational financial management. As mentioned in the previous section, dividend repatriations represent significant financial flows for parent companies and contribute to dividend payments. The factors that affect dividend repatriation policies can be grouped as follows.

(a) Financing factors
(b) Tax factors
(c) Managerial factors
(d) Timing factors

11.1 Financing factors

The factors that shape repatriation dividend policy within the multinational firm are the payment of dividends to external shareholders, the level of investment planned by the parent company, after-tax profits and financing policies.

Repatriation policies may reflect financing concerns of parents who draw on subsidiary cash flows to finance domestic expenses. Two examples of such domestic expenses are dividend payments to external shareholders and capital expenditures in the home countries.

11.2 Investment financing

Dividend repatriations from foreign affiliates may offer an attractive source of finance for domestic investment expenditures, despite possible associated tax costs, especially when alternative forms of finance are costly. This is true for parent companies with profitable domestic investment opportunities that already maintain large amounts of external debt and do not wish to increase the level of borrowing even further. Another case is when companies need to expand fast into areas and profitability is not sufficient to finance the expansion.

One of the strong implications of the US tax treatment of foreign income is that US multinational corporations should not simultaneously remit dividends from low-tax foreign locations and transfer equity funds into the same foreign locations. Doing so generates a home-country tax liability that could be easily avoided simply by reducing both dividends and equity transfers.

11.3 Dividend policy

Dividend repatriations from foreign affiliates may also offer an attractive source of finance for payments of dividends to common shareholders, especially when the parent company may prefer a smooth dividend payment pattern and domestic profitability is in decline. The dividend payments of a subsidiary may also be affected by the dividend policy of the parent company. For example, if the parent company operates a constant payout ratio policy, then the subsidiary will have to adopt a constant payout ratio policy too.

Empirical evidence shows that dividend payments to parent companies tend to be regular and multinational firms behave as though they select target payouts for their foreign affiliates, gradually adjusting payouts over time in response to changes in earnings.

11.4 Tax regime and dividend payments

Tax considerations are thought to be the primary reason for the dividend policies inside the multinational firm. For example, the parent company may reduce its overall tax liability by, for example, receiving larger amounts of dividends from subsidiaries in countries where undistributed earnings are taxed.

For subsidiaries of UK companies, all foreign profits, whether repatriated or not, are liable to UK corporation tax, with a credit for the tax that has already been paid to the host country. Similarly, the US Government does not distinguish between income earned abroad and income earned at home and gives credit to multinational corporations (MNCs) headquartered in the US for the amount of tax paid to foreign governments.

Example

Assume that the corporate tax rate in the home country is 40% and in the overseas country where a subsidiary is located it is 30%. Assume that both the parent company and the subsidiary have pre-tax profits of $1,000.

Taxes to foreign government = 1,000 × 30% = 300
MNC's profit after foreign tax = 1,000 – 300 = 700
US taxes = 1,000 × 40% = 400
Foreign tax credit = 300
Net tax to IRS = 400 – 300 = 100
Total taxes = 300 + 100 = 400

11.5 Managerial control

Another reason that may determine repatriation policies is the inability to fully monitor foreign managers. Regularised dividend payments restrict the financial discretion of foreign managers, thereby reducing associated agency problems. Conflicts of interest are most apt to arise when ownership is divided, as local owners may influence managers to undertake transactions at other than market prices. Control considerations inside the firm may explain the tax-penalised behaviour especially when affiliates are partially owned.

Finally, the desire to control corporate managers around the world carries implications for dividend policies. A multinational firm's central management can use financial flows within the firm to evaluate the financial prospects and needs of far-flung foreign affiliates and to limit the discretion of foreign managers. As this observation suggests, it may be sensible to mandate dividend payments to police and monitor foreign managers, limit their ability to misallocate funds, and extract returns on investments – much as public shareholders use dividends to monitor and control their firms.

11.6 Timing of dividend payments

So far we have concentrated on the size of repatriated dividends. The timing of payments may be equally important. For example, a subsidiary may adjust its dividend payments to a parent company in order to benefit from expected movements in exchange rates. A company would like to collect early (lead) payments from currencies vulnerable to depreciation and to collect late (lag) from currencies which are expected to appreciate.

Also, given that tax liabilities are triggered by repatriation, these tax liabilities can be deferred by reinvesting earnings abroad rather than remitting dividends to parent companies. The incentive to defer repatriation is much stronger for affiliates in low-tax countries, whose dividends trigger significant parent tax obligations, than they are for affiliates in high-tax countries – particularly since taxpayers receive net credits for repatriations from affiliates in countries with tax rates that exceed the parent country tax rate.

4 The treasury management function

Treasury management in a modern enterprise covers a number of areas, including liquidity management, funding management, currency management and corporate finance.

One way in which you can demonstrate competence in the performance objective 'manage cash using active cash management and treasury systems' is to manage cash on a centralised basis to both maximise returns and minimise charges. This section introduces the treasury management function and how it can be used to pool cash from various sources which can be placed on deposit.

4.1 Treasury management

Large companies rely heavily for both long-term and short-term funds on the financial and currency markets. To manage cash (funds) and currency efficiently, many large companies have set up a separate treasury department.

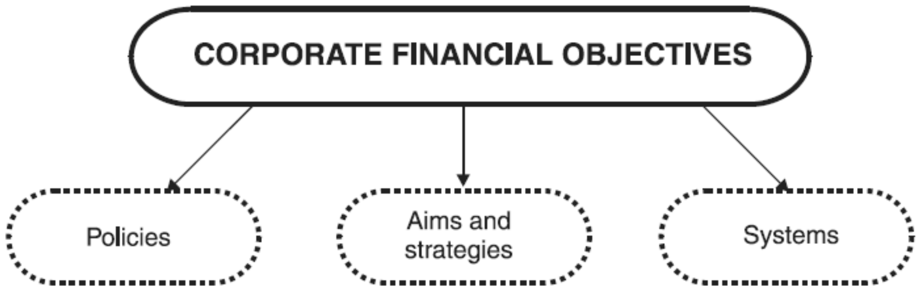
The Association of Corporate Treasurers' definition of treasury management is 'the corporate handling of all financial matters, the generation of external and internal funds for business, the management of currencies and cash flows, and the complex strategies, policies and procedures of corporate finance'.

A treasury department, even in a large company, is likely to be quite small, with perhaps a staff of three to six qualified accountants, bankers or corporate treasurers working under a treasurer, who is responsible to the finance director. In some cases, where the company or organisation handles very large amounts of cash or foreign currency dealings, and often has large cash surpluses, the treasury department might be larger.

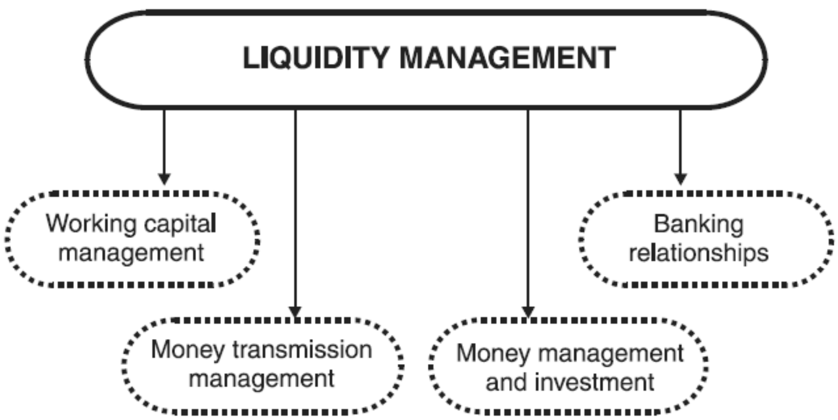
4.2 The role of the treasurer

The diagrams below are based on the Association of Corporate Treasurers' list of experience it requires from its student members before they are eligible for full membership of the Association. Required experience gives a good indication of the roles of treasury departments.

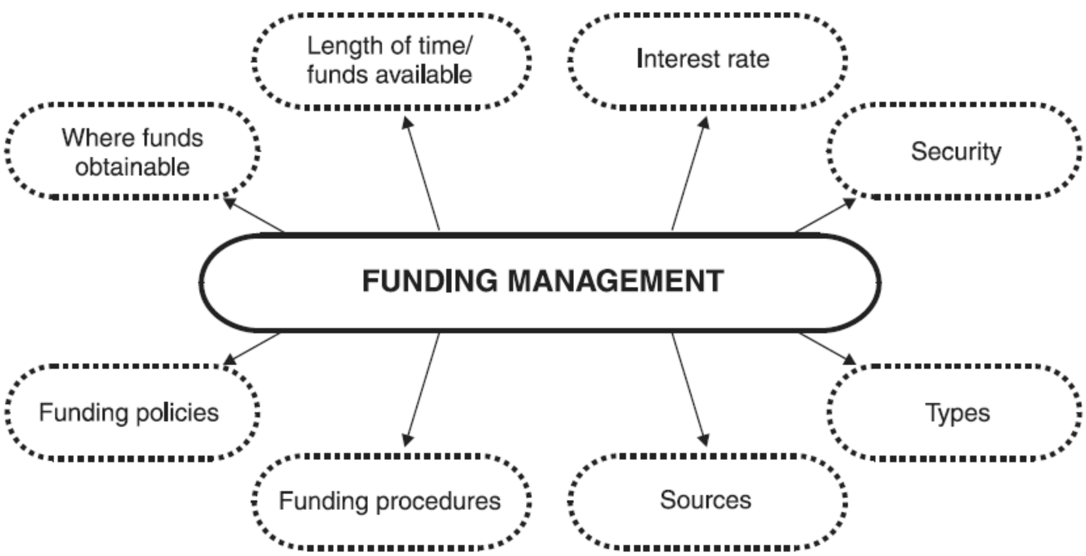
(a) Corporate financial objectives



(b) Liquidity management: making sure the company has the liquid funds it needs, and invests any surplus funds, even for very short terms.

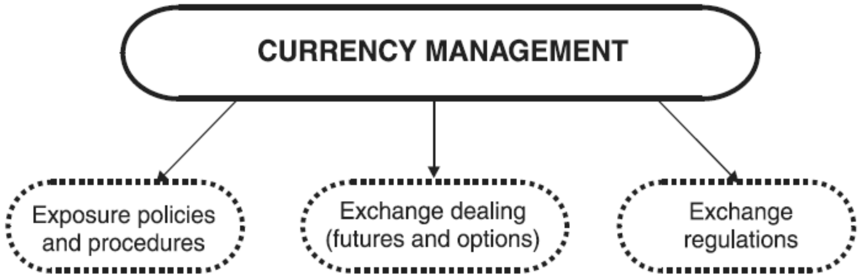


(c) Funding management



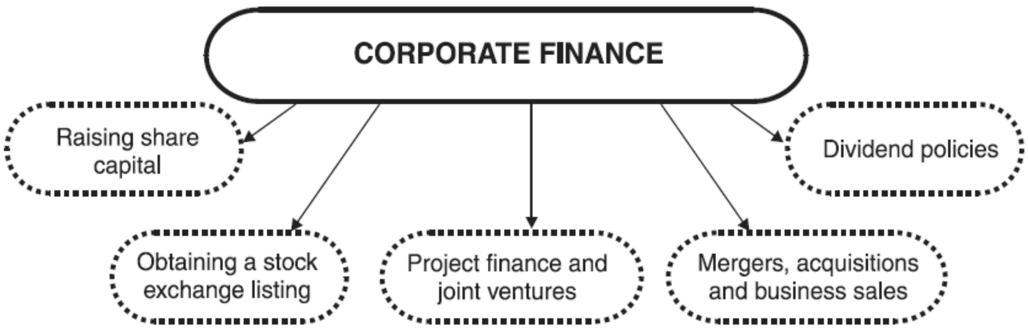
Funding management is concerned with all forms of borrowing, and alternative sources of funds, such as leasing and factoring.

(d) Currency management



Currency dealings can save or cost a company considerable amounts of money, and the success or shortcomings of the corporate treasurer can have a significant impact on the statement of profit or loss of a company which is heavily involved in foreign trade.

(e) Corporate finance



The treasury department has a role in all levels of decision making within the company. It is involved with strategic decisions, such as dividend policy and the raising of capital, tactical decisions, such as risk management, and operational decisions, such as the investment of surplus funds.

4.3 Treasury policy

All treasury departments should have a formal statement of treasury policy and detailed guidance on treasury procedures. The aims of a treasury policy are to enable managers to establish direction, specify parameters and exercise control, and also provide a clear framework and guidelines for decisions.

The guidance needs to cover the roles and responsibilities of the treasury function, the risks requiring management, authorisation and dealing limits.

Guidance on risks should cover:

- Identification and assessment methodology
- Criteria including tolerable and unacceptable levels of risk
- Management guidelines, covering risk elimination, risk control, risk retention and risk transfer
- Reporting guidelines

The areas that might be covered include:

- Counterparty exposure, including limits for each counterparty and monitoring of exposures in relation to the limits
- Currency and interest rate risk, such as hedging methods, authorised instruments and exposure limits
- Funding risk, including limits and targets for different sources of funding
- Liquidity management, including permitted banks, netting and inter-group procedures

- Investment management, covering sources of funds, authorised counterparties and instruments, and inter-company funding
- Bank relationships specifying criteria for the choice of bank

The guidance must also include guidance on measurement of treasury performance. Measurement must cover both the management of risk and the financial contribution the department makes.

4.4 Advantages of a separate treasury department

Advantages of having a treasury function which is separate from the financial control function are as follows.

(a) Centralised liquidity management avoids mixing cash surpluses and overdrafts in different localised bank accounts.

(b) Bulk cash flows allow lower bank charges to be negotiated.

(c) Larger volumes of cash can be invested, giving better short-term investment opportunities.

(d) Borrowing can be agreed in bulk, probably at lower interest rates than for smaller borrowings.

(e) Currency risk management should be improved, through matching of cash flows in different subsidiaries. There should be less need to use expensive hedging instruments, such as option contracts.

(f) A specialist department can employ staff with a greater level of expertise than would be possible in a local, more broadly based, finance department.

(g) The company will be able to benefit from the use of specialised cash management software.

(h) Access to treasury expertise should improve the quality of strategic planning and decision making.

4.5 Centralised or decentralised cash management?

Centralising the treasury management function allows businesses to employ experts, deal in bulk cash flows and therefore take advantage of lower bank charges and avoid a mix of surpluses and deficits. However, decentralised cash management can be more responsive to local needs.

A large company may have a number of subsidiaries and divisions. In the case of a multinational, these will be located in different countries. It will be necessary to decide whether the treasury function should be centralised.

With centralised cash management, the central treasury department effectively acts as the bank to the group. The central treasury has the job of ensuring that individual operating units have all the funds they need at the right time.

4.5.1 Advantages of a specialist centralised treasury department

(a) Centralised liquidity management avoids having a mix of cash surpluses and overdrafts in different local bank accounts and facilitates bulk cash flows, so that lower bank charges can be negotiated.

(b) Larger volumes of cash are available to invest, giving better short-term investment opportunities (for example, money market deposits, high interest accounts and CDs).

(c) Any borrowing can be arranged in bulk, at lower interest rates than for smaller borrowings, and perhaps on the eurocurrency or eurobond markets.

(d) Foreign currency risk management is likely to be improved in a group of companies. A central treasury department can match foreign currency income earned by one subsidiary with expenditure in the same currency by another subsidiary. In this way, the risk of losses on adverse exchange rate changes can be avoided without the expense of forward exchange contracts or other 'hedging' (risk-reducing) methods.

(e) A specialist treasury department will employ experts with knowledge of dealing in futures, eurocurrency markets, taxation, transfer prices and so on. Localised departments would not have such expertise.

(f) The centralised pool of funds required for precautionary purposes will be smaller than the sum of separate precautionary balances which would need to be held under decentralised treasury arrangements.

(g) Through having a separate profit centre, attention will be focused on the contribution to group profit performance that can be achieved by good cash, funding, investment and foreign currency management.

(h) Centralisation provides a means of exercising better control through use of standardised procedures and risk monitoring. Standardised practices and performance measures can also create productivity benefits.

4.5.2 Possible advantages of decentralised cash management

(a) Sources of finance can be diversified and can be matched with local assets.

(b) Greater autonomy can be given to subsidiaries and divisions because of the closer relationships they will have with the decentralised cash management function.

(c) The decentralised treasury function may be able to be more responsive to the needs of individual operating units.

However, since cash balances will not be aggregated at group level, there will be more limited opportunities to invest such balances on a short-term basis.

4.5.3 Centralised cash management in the multinational firm

If cash management within a multinational firm is centralised, each subsidiary holds only the minimum cash balance required for transaction purposes. All excess funds will be remitted to the central treasury department.

Funds held in the central pool of funds can be returned quickly to the local subsidiary by telegraphic transfer or by means of worldwide bank credit facilities. The firm's bank can instruct its branch office in the country in which the subsidiary is located to advance funds to the subsidiary.

Question — **Treasury centralisation**

Touten is a US registered multinational company with subsidiaries in 14 countries in Europe, Asia and Africa. The subsidiaries have traditionally been allowed a large amount of autonomy, but Touten is now proposing to centralise most of the group treasury management operations.

Required

Acting as a consultant to Touten, prepare a memo suitable for distribution from the group finance director to the senior management of each of the subsidiaries explaining:

(a) The potential benefits of treasury centralisation

(b) How the company proposes to minimise any potential problems for the subsidiaries that might arise as a result of treasury centralisation

Answer

MEMORANDUM

To: Directors of all foreign subsidiaries

From: Group Finance Director

Date: 1 July 20X0

Centralisation of treasury management operations

At its last meeting, the board of directors of Touten made the decision to centralise group treasury management operations. A further memo giving detailed plans will be circulated shortly, but my objective in this memo is to outline the potential benefits of treasury centralisation and how any potential problems arising at subsidiaries can be minimised. Most of you will be familiar with the basic arguments, which we have been discussing informally for some time.

What it means

Centralisation of treasury management means that most decisions on borrowing, investment of cash surpluses, currency management and financial risk management will be taken by an enhanced central treasury team, based at head office, instead of by subsidiaries directly. In addition, we propose to set most transfer prices for inter-company goods and services centrally.

The potential benefits

The main benefits are:

(a) Cost savings resulting from reduction of unnecessary banking charges
(b) Reduction of the group's total taxation charge
(c) Enhanced control over financial risk

Reduction in banking charges will result from:

(a) Netting off inter-company debts before settlement. At the moment we are spending too much on foreign exchange commission by settling inter-company debts in a wide range of currencies through the banking system.

(b) Knowledge of total group currency exposure from transactions. Amounts receivable in one subsidiary can hedge payables in another, eliminating unnecessary hedging by subsidiaries.

(c) Knowledge of the group's total cash resources and borrowing requirement. This will reduce the incidence of one company lending cash while a fellow subsidiary borrows at a higher interest rate and will also eliminate unnecessary interest rate hedging. It will also facilitate higher deposit rates and lower borrowing rates.

Reduction in the group's tax charge will be made possible by a comprehensive centrally set transfer pricing policy.

Enhanced control over financial risks will be possible because we will be able to develop a central team of specialists who will have a clear-cut strategy on hedging and risk management. Many of you have requested help in this area.

This team will be able to ensure that decisions are taken in line with group strategy and will also be able to provide you with enhanced financial information to assist you with your own decision making.

Potential problems for subsidiaries and their solution

Our group culture is one of decentralisation and enablement of management at individual subsidiary level. There is no intention to change this culture. Rather, it is hoped that releasing you from specialist treasury decisions will enable you to devote more time to developing your own business units.

However, the system can only work properly if information exchange between head office and subsidiaries is swift and efficient. Enhanced computer systems are to be provided at all centres to assist you with daily reports. It is also important that you keep head office informed of all local conditions that

12 Transfer pricing

Transfer prices are set by the MNC not only to recover the cost of services and goods provided but also to achieve objectives such as tax liability minimisation and to offset host country policies.

MNCs supply their affiliates with capital, technology and managerial skills, for which the parent firm receives a stream of dividend and interest payments, royalties and licence fees. At the same time, significant intra-firm transfers of goods and services occur. For example, the subsidiary may provide the parent company with raw materials, whereas the parent company may provide the subsidiary with final goods for distribution to consumers in the host country. For intra-firm trade both the parent company and the subsidiary need to charge prices. These prices for goods, technology or services between wholly or partly owned affiliates of the multinational are called transfer prices.

A transfer price may be defined as the price at which goods or services are transferred from one process or department to another or from one member of a group to another.

The extent to which costs and profit are covered by the transfer price is a matter of company policy. A transfer price may be based on any of the following.

- Standard cost
- Marginal cost: at marginal cost or with a gross profit margin added
- Opportunity cost
- Full cost: at full cost, or at a full cost plus price
- Market price
- Market price less a discount
- Negotiated price, which could be based on any of the other bases

A transfer price based on cost might be at marginal cost or full cost, with no profit or contribution margin, but in a profit centre system it is more likely to be a price based on marginal cost or full cost plus a margin for contribution or profit. This is to allow profit centres to make a profit on work they do for other profit centres, and so earn a reward for their effort and use of resources on the work.

Transfers based on market price might be any of the following.

(a) The actual market price at which the transferred goods or services could be sold on an external market

(b) The actual external market price, minus an amount that reflects the savings in costs (for example selling costs and bad debts) when goods are transferred internally

(c) The market price of similar goods which are sold on an external market, although the transferred goods are not exactly the same and do not themselves have an external market

(d) A price sufficient to give an appropriate share of profit to each party

12.1 The level of transfer prices

The size of the transfer price will affect the costs of one profit centre and the revenues of another. Since profit centre managers are held accountable for their costs, revenues and profits, they are likely to dispute the size of transfer prices with each other, or disagree about whether one profit centre should do work for another or not. Transfer prices affect the behaviour and decisions of profit centre managers.

If managers of individual profit centres are tempted to make decisions that are harmful to other divisions and are not congruent with the goals of the organisation as a whole, the problem is likely to emerge in disputes about the transfer price.

Disagreements about output levels tend to focus on the transfer price. There is presumably a profit-maximising level of output and sales for the organisation as a whole. However, unless each profit centre also maximises its own profit at the corresponding level of output, there will be interdivisional disagreements about output levels and the profit-maximising output will not be achieved.

12.2 The advantages of market value transfer prices

Giving profit centre managers the freedom to negotiate prices with other profit centres as though they were independent companies will tend to result in market-based transfer prices.

(a) In most cases where the transfer price is at market price, internal transfers should be expected, because the buying division is likely to benefit from a better quality of service, greater flexibility and dependability of supply.

(b) Both divisions may benefit from lower costs of administration, selling and transport.

A market price as the transfer price would therefore result in decisions which would be in the best interests of the company or group as a whole.

12.3 The disadvantages of market value transfer prices

Market value as a transfer price does have certain disadvantages.

(a) The market price may be temporary, induced by adverse economic conditions or dumping, or it might depend on the volume of output supplied to the external market by the profit centre.

(b) A transfer price at market value might, under some circumstances, act as a disincentive to use up any spare capacity in the divisions. A price based on incremental cost, in contrast, might provide an incentive to use up the spare resources in order to provide a marginal contribution to profit.

(c) Many products do not have an equivalent market price, so that the price of a similar product might be chosen. In such circumstances, the option to sell or buy on the open market does not exist.

(d) There might be an imperfect external market for the transferred item so that, if the transferring division tried to sell more externally, it would have to reduce its selling price.

(e) Internal transfers are often cheaper than external sales, with savings in selling costs, bad debt risks and possibly transport costs. It would therefore seem reasonable for the buying division to expect a discount on the external market price, and to negotiate for such a discount.

12.5 Motivations for transfer pricing

In deciding on their transfer pricing policies, MNCs take into account many internal and external factors or motivations for transfer pricing. In terms of internal motivations these include the following.

Performance evaluation

When different affiliates within a multinational are treated as standalone profit centres, transfer prices are needed internally by the multinational to determine profitability of the individual divisions. Transfer prices which deviate too much from the actual prices will make it difficult to properly monitor the performance of an affiliated unit.

Management incentives

If transfer prices used for internal measures of performance by individual affiliates deviate from the true economic prices, and managers are evaluated and rewarded on the basis of the distorted profitability, then it may result in corporate managers behaving in an irresponsible way.

Cost allocation

When units within the multinational are run as cost centres, subsidiaries are charged a share of the costs of providing the group service function so that the service provider covers its costs plus a small mark-up. Lower or higher transfer prices may result in a subsidiary bearing less or more of the overheads.

Financing considerations

Transfer pricing may be used in order to boost the profitability of a subsidiary, with the parent company undercharging the subsidiary. Such a boost in the profitability and its credit rating may be needed by the subsidiary in order to succeed in obtaining funds from the host country.

Transfer pricing can also be used to disguise the profitability of the subsidiary in order to justify high prices for its products in the host country and to be able to resist demands for higher wages.

Several external motivations can affect the multinational's choice of transfer prices. Because multinationals operate in two or more jurisdictions, transfer prices must be assigned for intra-firm trade that crosses national borders.

Taxes

MNCs use transfer pricing to channel profits out of high tax rate countries into lower ones. A parent company may sell goods at lower than normal prices to its subsidiaries in lower tax rate countries and buy from them at higher than normal prices. The resultant loss in the parent's high-tax country adds significantly to the profits of the subsidiaries. An MNC reports most of its profits in a low-tax country, even though the actual profits are earned in a high-tax country.

Tariffs

Border taxes, such as tariffs and export taxes, are often levied on crossborder trade. Where the tax is levied on an *ad valorem* basis, the higher the transfer price, the larger the tax paid per unit. Whether an MNC will follow high transfer price strategy or not may depend on its impact on the tax burden. When border taxes are levied on a per-unit basis (ie specific taxes), the transfer price is irrelevant for tax purposes.

Rule of origin rule

Another external factor is the need to meet the rule of origin that applies to crossborder flows within a free trade area. Since border taxes are eliminated within the area, rules of origin must be used to determine eligibility for duty-free status. Over- or underinvoicing inputs is one way to avoid customs duties levied on products that do not meet the rule of origin test.

Exchange control and quotas

Transfer pricing can be used to avoid currency controls in the host country. For example, a constraint in profit repatriation could be avoided by the parent company charging higher prices for raw materials, or higher fees for services provided to the subsidiary. The parent company will have higher profits and a higher tax liability and the subsidiary will have lower profitability and a lower tax liability.

When the host country restricts the amount of foreign exchange that can be used to import goods, then a lower transfer price allows a greater quantity of goods to be imported.

13 Regulation of transfer pricing

MNCs have to adhere to pricing guidelines to prevent exploitation of the host country.

13.1 The problem of transfer price manipulation

As we have discussed in the previous section, transfer pricing is a normal, legitimate and, in fact, required activity. Firms set prices on intra-firm transactions for a variety of perfectly legal and rational internal reasons and, even where pricing is not required for internal reasons, governments may require it in order to determine how much tax revenues and customs duties are owed by the MNC. Transfer price manipulation, on the other hand, exists when MNCs use transfer prices to evade or avoid payment of taxes and tariffs, or other controls that the Government of the host country has put in place.

Governments worry about transfer price manipulation because they are concerned with the loss of revenues through tax avoidance or evasion and they dislike the loss of control. Overall MNC profits after taxes may be raised by either under- or overinvoicing the transfer price; such manipulation for tax purposes, however, comes at the expense of distorting other goals of the firm; in particular, evaluating management performance.

Case Study

'In November 2012, Starbucks's head of finance was forced to portray his company as a perennial commercial flop, in order to account for its peculiar failure to record a taxable profit in the UK for 14 of the last 15 years.

... Starbucks said that it sourced UK coffee from its wholesale trading subsidiary in Switzerland. That may be sensible commercially – it's cheaper to have one team responsible for sourcing all of Starbucks' coffee ... but it is hard to escape the conclusion that Switzerland would not be a major centre for coffee trading in the first place if it did not charge a lowly 12% tax rate on the trading profits.'

Starbucks also charges its UK operations for use of its brand name, technology and engineering support.

'Transfer pricing is not a new problem ... and is perfectly legitimate so long as they are done at an arm's length fair market price.'

Starbucks points to the fact that franchise operators in the UK willingly pay these charges and that this is 'the same fee it charges its own loss making business in the UK'.

(Source: 'Corporate tax avoidance: how do companies do it?', BBC website 4 Dec 2012)