ACCOUNTING, FINANCE AND CONTROL 2018-2019

QUICK EXERCISES – TRANSFER PRICING

For each question, select the correct answer (only 1 answer is correct)

1. In which of the following cases, the transfer price based on the market is difficult to apply:
   - ☐ When internal negotiation costs are likely to be high
   - ☐ When the selling units have a shortage in production capacity
   - ☐ When the products/services involved in the transactions are characterized by a market with unstable prices
   - ☐ When the transfer price has fiscal implications

2. How does the Dual Transfer Price scheme work?
   - ☐ By setting a unique reference price at which the product/service can be exchanged in internal transactions based on the external market
   - ☐ By correcting the market price, taking into account lower transaction and administrative costs for internal transactions
   - ☐ By averaging the price of the market, when there is price-market variability
   - ☐ By defining different selling and purchasing prices for the internal transactions, managing the difference as a corporate account.

3. What of the following is a disadvantage of a Negotiated Transfer Price?
   - ☐ The integration among business units decreases
   - ☐ Negotiated transfer prices cannot be used in turbulent contexts
   - ☐ These systems should be used coupled with market-based Transfer prices
   - ☐ Negotiated Transfer Prices usually might lead to a suboptimal saturation of the production capacity of the selling units

4. What of the following information is not relevant for selecting the most appropriate Transfer Price System?
   - ☐ The fact that Business Units are in different countries, having to deal with different fiscal policies
   - ☐ The turbulence of the external context of the companies
   - ☐ The desired level of autonomy of the different Business Units
   - ☐ The minimum set of resources required for running each organizational unit

5. One of the following is not a goal of transfer pricing

- ☐ To coordinate the activities of various responsibility centres
- ☐ To decreases the buying segment’s operating profit
- ☐ To motivate managers to perform in the company’s best interest
- ☐ To serve as a performance measure for business units

6. What is a risk of basing transfer prices on full absorption cost system:

- ☐ Full-cost-based transfer prices can lead the buying division to view costs that are non-unit-level costs for the company as unit-level costs to the buying division. Causing faulty decision making.
- ☐ Full-cost-based transfer prices can lead to divisiveness and competition among division managers
- ☐ Full-cost-based transfer prices can affect the assignment of income from one jurisdiction to another
- ☐ None of the above

7. Which of the following is NOT a purpose of a Transfer Pricing System:

- ☐ To communicate data that will lead to goal-congruent decisions
- ☐ To define the full cost of the products of all the divisions
- ☐ To motivate managers to perform in the company’s best interest
- ☐ Provide information that motivates divisional managers to make good economic decisions
- ☐ To plan tax, by moving profits between divisions or locations

8. Business Unit XYZ decides to buy from an external supplier 1,000 sensors ($75/unit) that are manufactured also internally at Division ABC, which has sufficient capacity available and produces with a variable cost per unit of $50/u and fixed overhead of $30. Which of the following statements is true:

- ☐ Division ABC should improve its efficiency since at present is not attractive for internal transactions
- ☐ By this transaction, the company will lose $ 25.000
- ☐ By this transaction, both the Business Unit XYZ and the company will save $ 5,000
- ☐ None of the above

Solution

$$\left(\frac{75\$}{unit} - \frac{50\$}{unit}\right) 1.000\ unit = \$25.000$$

9. Company A manages dual transfer prices. The Plastic Business Unit (BU)of the company wants to purchase components from the Chemical BU at a maximum price of 85 $/unit (5 $/unit less than the market price). The amount that the Chemical BU is willing to receive is at least 95$/unit. What could be true about this internal transaction?

- ☐ The market is less competitive than the chemical Business Unit
- ☐ The internal transaction will not happen
- ☐ There is a corporate account that will be charged with $10 for each unit sell in the transaction.
- ☐ None of the above

Solution

$$\begin{aligned} &Corporate\ account \\ &\qquad = min.to\ receive\ from\ the\ upstream\ division \\ &\qquad - max.to\ give\ from\ the\ downstream\ division\ = 10\ \$/unit \end{aligned}$$

10. Business Unit CDE of Nano Company Ltd. needs to purchase some electronic devices, either from the XYZ Business Unit or from an external supplier. A reliable supplier might provide the required 2,000 units for 50,00 €/unit.

Business Unit XYZ so far can produce up to 10,000 units and it currently sells 7,000 units to an external customer at 70,00 €/unit without any additional external market. Labour can be scaled up and down as needed. The breakdown of its cost structure is as follow:

Direct materials	€/u 5.00
Direct labour	€/u 15.00
Variable overhead	€/u 20.00
Fixed overhead	€/u 25.00
Total	**€/u 65.00**

The company runs a market-based transfer policy that sets as transfer price the current prices on the market decreased by 5% to take into account potential savings respect to external transactions.

Given the above, which of the following statement is FALSE?

- ☐ CDE will be willing to pay up to 50 € for each electronic device, and XYZ will accept at least 40 € per unit
- ☐ CDE will be willing to pay up to 50 € for each electronic device, and XYZ will accept at least 65 €, so the internal transaction could not take place
- ☐ The market-based price policy implies that XYZ will set a price of 47,5 €/unit
- ☐ If XYZ get an extra customer to sell 3000 units more. It will need to consider the opportunity cost of selling to CDE.

Solution

a) $max = price\ of\ the\ external\ supplier: \frac{50€}{\text{unit}}$

$min = price\ of\ the\ marginal\ costs: €/u\ 20 + €/u15 + €/u5 = €/u40$

c) $TP = 95\%(market\ price) = 95\%\left(50\,\frac{€}{unit}\right) = 47{,}5\ €/unit$

d) Fixed overhead will need to be considered