Bhimani et al
Chapter Eighteen: Transfer Pricing

Suggested solutions to some of the questions

18.1 A management control system is a means of gathering and using information to aid and coordinate the process of making planning and control decisions throughout the organisation and to guide employee behaviour. The goal of the system is to improve the collective decisions within an organisation.

18.2 To be effective, management control systems should be: (a) closely aligned to an organisation's strategies and goals, (b) designed to fit the organisation's structure and the decision-making responsibility of individual managers and (c) able to motivate managers and employees to put in effort to attain selected goals desired by top management.

18.3 Motivation combines goal congruence and effort. Motivation is the desire to attain a selected goal specified by top management (the goal-congruence aspect) combined with the resulting drive or pursuit towards that goal (the effort aspect).

18.4 Chapter 18 cites five benefits of decentralisation:

> **1** Creates greater responsiveness to local needs.
> **2** Leads to quicker decision making.
> **3** Increases motivation.
> **4** Aids management development and learning.
> **5** Sharpens the focus of managers.

Chapter 18 cites four costs of decentralisation:

> **1** Leads to suboptimal decision making.
> **2** Results in duplication of activities.
> **3** Decreases loyalty toward the organisation as a whole.
> **4** Increases costs of gathering information.

18.5 No. Organisations typically compare the benefits and costs of decentralisation on a function-by-function basis. For example, companies with highly decentralised operating divisions frequently have centralised income tax strategies.

18.6 No. A transfer price is the price one subunit of an organisation charges for a product or service supplied to another subunit of the same organisation. The two segments can be cost centres, profit centres or investment centres. For example, the allocation of service department costs to production departments that are set up as either cost centres or investment centres is an example of transfer pricing.

18.7 Transferring products or services at market prices generally leads to optimal decisions when: (a) the intermediate market is perfectly competitive, (b) interdependencies of subunits are minimal and (c) there are no additional costs or benefits to the organisation as a whole in using the market instead of transacting internally.

18.8 Reasons why a dual-pricing approach to transfer pricing is not widely used in practice include:

> **1** The manager of the division using a cost-based method does not have sufficient incentives to control costs.
> **2** This approach does not provide clear signals to division managers about the level of decentralisation top management wants.
> **3** This approach tends to insulate managers from the frictions of the market place.

18.9 Yes. The general transfer-pricing guideline specifies that the minimum transfer price equals the additional *outlay costs* per unit incurred up to the point of transfer *plus* the *opportunity costs* per unit to the supplying division. When the supplying division has idle capacity, its opportunity costs are zero; when the supplying division has no idle capacity, its opportunity costs are positive. Hence the minimum transfer price will vary depending on whether the supplying division has idle capacity or not.

18.10 Alternative transfer-pricing methods can result in sizeable differences in the reported operating income of divisions in different income tax jurisdictions. If these jurisdictions have different tax rates or deductions, the net income of the company as a whole can be affected by choice of the transfer-pricing method.

18.11 Goals of public accounting firms.
If public accounting firms stress that each individual should have a high percentage of chargeable time, individuals will attempt to both maximise the percentage of their time charged to clients and minimise the time spent on non-chargeable tasks. Many accounting firms now recognise that their goals (growth, profitability, intellectual challenge, and so on) may not be promoted if all individuals focus on maximising the percentage of their day-to-day time charged to clients. Aspects critical to promoting goals that are not chargeable to clients include:

a Bidding for new clients.
b Superiors providing training to juniors.
c Continuing education to keep personnel up to date.
d General public relations aimed at promoting the profile of a well-known, reputable and professional firm.

18.12 Decentralisation, goal congruence, responsibility centres.
1 The environmental management organisation appears to be decentralised because managers of the environmental management group have considerable freedom to make decisions. They can choose which projects to work on and which projects to reject.
2 The environmental management group is a cost centre. The group is required to charge the operating divisions for environmental services at cost and not at market prices that would help the group earn a profit.
3 The benefits of structuring the environmental management group in this way are:
i The operating managers have incentives to carefully weigh and conduct cost–benefit analyses before requesting the environmental group’s services.
ii The operating managers have an incentive to follow the work and the progress made by the environmental team.
iii The environmental group has incentives to fulfil the contract, to do a good job in terms of cost, time and quality and to satisfy the operating divisions in order to continue to get business.

The problems in structuring the environmental group in this way are:
i The contract requires extensive internal negotiations in terms of cost, time and technical specifications.
ii The environmental group needs to continuously ‘sell’ its services to the operating divisions and this could potentially result in loss of morale.
iii Experimental projects that have long-term potential may not be undertaken because operating division managers may be reluctant to undertake projects that are costly and uncertain whose benefits will only be realised well after they have left the division.
To the extent that the focus of the environmental group is on short-run projects demanded by the operating divisions, the current structure leads to goal congruence and motivation. Goal congruence is achieved because both operating divisions and the environmental group have an incentive to work towards the organisational goals of reducing pollution and improving the environment. The operating divisions will be motivated to utilise the services of the environmental group to achieve the environmental goals set for them

by top management. The environmental group will be motivated to deliver high-quality services in a cost-effective way in order to continue to create a demand for their services. The one issue that top management needs to guard against is that experimental projects with long-term potential that are costly and uncertain may not be undertaken under the current structure. Top management may want to set up a committee to study and propose such long-run projects for consideration and funding by corporate management.

18.13 Transfer-pricing dispute.

1 The company as a whole will not benefit if Division C buys on the outside market.

Purchase costs from outsider, 1,000 units × €135	€135,000
Deduct: Savings in variable costs by reducing Division A output, 1,000 units × €120	120,000
Net cost (benefit) to company as a whole by buying from outside	€15,000

2 The company will benefit if C purchases from the outside supplier:

Purchase costs from outsider, 1,000 units × €135		€135,000
Deduct: Savings in variable costs, 1,000 units × €120	€120,000	
Savings due to A's equipment and facilities being assigned to other operations	18,000	138,000
Net cost (benefit) to company as a whole by buying from outside		€(3,000)

3 The company will benefit if C purchases from the outside supplier:

Purchase costs from outsider, 1,000 units × €115	€115,000
Deduct: Savings in variable costs by reducing Division A output, 1,000 units × €120	120,000
Net cost (benefit) to company as a whole by buying from outside	€(5,000)

The three requirements are summarised below (in thousands):

	(1)	**(2)**	**(3)**
Total purchase costs from outsider	€135	€135	€115
Total relevant costs if purchased from Division A			
Total incremental (outlay) costs if purchased from A	120	120	120
Total opportunity costs if purchased from A	–	18	–
Total relevant costs if purchased from A	120	138	120
Operating income advantage (disadvantage) to company as a whole by buying from A	€15	€(3)	€(5)

Goal congruence would be achieved if the transfer price is set equal to the total relevant costs of purchasing from Division A.

18.14 Transfer-pricing problem.

The company as a whole would benefit in this situation if C purchased from outside suppliers. The €15,000 disadvantage to the company as a whole by purchasing from the outside supplier would be more than offset by the €30,000 contribution margin of A's sale of 1,000 units to other customers.

Purchase costs from outside supplier, 1,000 units × €135	€135,000
Deduct variable cost savings, 1,000 units × €120	120,000
Net cost to company as a whole by buying from outside	€15,000

A’s sales to other customers, 1,000 units × €155	€155,000
Deduct:	
Variable manufacturing costs, €120 × 1,000 units	€120,000
Variable marketing costs, €5 × 1,000 units	5,000
Variable costs	125,000
Contribution margin from A selling to other customers	€30,000