

Transfer Price

A **transfer price** is the price one subunit charges for a product or service supplied to another subunit of the same organization.

The transfer price is needed to compute for the selling subunit revenues and buying subunit purchase costs

affecting each subunit's operating income.

Intermediate products

are the products transferred between subunits of an organization.

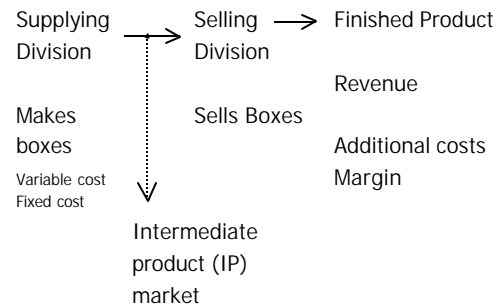
- Intermediate products can either be
- sold to an external customer
 - processed further by the receiving subunit.

Transfer Pricing

The rationale for transfer prices

- ❖ is that subunit managers, when evaluating decisions, need only focus on how their actions will affect subunit performance without evaluating their impact on company wide performance.
- ❖ Ideally, the method used should lead each subunit manager to make optimal decisions for the organization as a whole

Transfer prices



Transfer-Pricing Methods

Market-Based Transfer Prices

use the price of a similar product or service publicly listed

A perfectly competitive market exists

- ❖ when there is a homogeneous product
- ❖ with buying and selling prices equal
- ❖ individual buyers or sellers can not affect prices

In perfectly competitive markets can idle capacity exist

NO



Market-Based Transfer Prices

By using market-based transfer prices in a perfectly competitive market, a company can achieve the following:

- ❖ Goal congruence
- ❖ Management effort
- ❖ Good subunit performance evaluation
- ❖ Subunit autonomy

Imperfect Competition

When supply outstrips demand, market prices may have to drop lower.

Market share seeking prices may be expected to be temporary.

Which transfer price should be used for judging performance if lower prices have to prevail?

If all information is public – no problem.

If market conditions are known then TP could be chosen.

Interdependencies

∞ between subunits has to be minimal

Are costs of internal sales less than costs of external sales ?

packaging	customer service,
distribution costs	warranty expenses

Then sharing of cost savings could be a problem

Externalities

No other costs or benefits to the corporation whether there is market sourcing versus internal sourcing

Internal adjustments need to be made

Examples:

Car dealers:	Banks:
sales	deposits
vs. service	vs. credit card
vs. loans	vs. special services

Cost-Based Transfer Prices

Choose a transfer price based on the costs of producing the product

- ❖ ∞ are helpful when market prices are unavailable, inappropriate, or too costly to obtain.
- ❖ Many companies use transfer prices based on full costs.
- ❖ To approximate market prices, cost-based transfer prices are sometimes set at full cost plus a margin.

Negotiated Transfer Prices

In some cases, the subunits of a company are free to negotiate the transfer price between themselves and then to decide whether to buy and sell internally or deal with outside parties

Negotiated transfer prices arise from the outcome of a bargaining process.



Comparison of Methods

	Achieves Goal Congruence
Market Price:	Yes, if markets competitive
Cost-Based:	Often, but not always
Negotiated:	Yes

Comparison of Methods

	Useful for Evaluating Subunit Performance
Market Price:	Yes, if markets are competitive
Cost-Based:	Difficult, unless transfer price exceeds full cost
Negotiated:	Yes

Comparison of Methods

	Motivates management effort
Market Price:	Yes
Cost-Based:	Yes, if based on budgeted costs; less incentive if based on actual cost
Negotiated:	Yes

Comparison of Methods

	Preserves subunit autonomy
Market Price:	Yes, if markets competitive
Cost-Based:	No, it is rule based
Negotiated:	No / Yes; Negotiation strength

Comparison of Methods

	Other factors
Market Price:	No market may exist
Cost-Based:	Useful for determining full-cost; easy to implement
Negotiated:	Bargaining takes time and may need to be reviewed

General Guideline

Minimum transfer price =

Incremental outlay costs per unit incurred up to the point of transfer

+ Opportunity costs per unit to the selling division

The "correct" transfer price depends on the economic circumstances and the decision at hand.

General Guideline**outlay costs**

are the cash outflows that are directly associated with the production and transfer of the products and services.

opportunity costs

is the maximum profit foregone by the supplying division if the products are transferred internally.

= Best profit from other sources without transfer

- Best profit from other sources with transfer

[Could be negative if there are common fixed costs]

Other factors in transfer pricing

- ❖ Different divisions may have different minority "psuedo" equity outstanding
Chicago Tribune owns Cubs and its broadcaster WGN, which pays \$7.6 mn (along with Fox which pays \$13mn) to the cubs. Both show equal amount of games.
- ❖ Tax implications.

Multinational Transfer Pricing

- ❖ Transfer prices often have tax implications.
- ❖ Tax factors include not only income taxes, but also payroll taxes, customs duties, tariffs, sales taxes, and other levies on organizations.
- ❖ Section 482 of the U.S. Internal Revenue Service Code governs taxation of multinational transfer pricing.

Multinational Transfer Pricing

Section 482 requires that transfer prices for both tangible and intangible property between a company and its foreign division be set to equal the price that would be charged by an **unrelated third party** in a comparable transaction.

Transfer prices can reduce income tax payments by recognizing more income in low tax rate countries and less income in high tax rate countries.