CASE: Transfer Pricing; Divisional Performance

Stanco is a decentralised organisation with five divisions. The company's Electronics Division produces a variety of electronics items, including an XL5 circuit board. The division (which is operating at capacity) sells the XL5 circuit board to regular customers for £12.50 each. The circuit boards have a variable production cost of £8.25 each.

The company's Clock Division has asked the Electronics Division to supply it with a large quantity of XL5 circuit boards for only £9 each. The Clock Division, which is operating at only 60% of capacity, will put the circuit boards into a timing device that it will produce and sell to a large oven manufacturer. The cost of the timing device being manufactured by the Clock Division follows:

XL5 circuit board (desired cost)	£9.00
Other purchased parts (from outside vendors)	30.00
Other variable costs	20.75
Fixed overhead and administrative costs	10.00
Total cost per timing device	£69.75

The manager of the Clock Division feels that she can't quote a price greater than £70 per timing device to the oven manufacturer if her division is to get the job. As shown above, in order to keep the price at £70 or less, she can't pay more than £9 per unit to the Electronics Division for the XL5 circuit boards. Although the £9 price for the XL5 circuit boards represents a substantial discount from the normal £12.50 price, she feels that the price concession is necessary for her division to get the oven manufacturer contract and thereby keep its core of highly trained people.

The company uses return on investment (ROI) to measure divisional performance.

Required:

1. Assume that you are the manager of the Electronics Division. Would you recommend that your division supply the XL5 circuit boards to the Clock Division for £9 each as requested? Why or why not? Show all computations.
2. Would it be profitable for the company as a whole for the Electronics Division to supply the Clock Division with the circuit boards for £9 each? Explain your answer.
3. In principle, should it be possible for the two managers to agree to a transfer price in this particular situation? If so, within what range would that transfer price lie?
4. Discuss the organisational and manager behaviour problems, if any, inherent in this situation. What would you advise the company's managing director to do in this situation?