I. **Appendix 11A: transfer pricing (Slide #1 is a title slide)**

A. **Key concepts/definitions**

i. A **transfer price** is the price charged when one segment of a company provides goods or services to another segment of the company. While domestic transfer prices have no direct effect on the entire company’s reported profit, they can have a dramatic effect on the reported **profitability of a division**.

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ii. The fundamental objective in setting transfer prices is to motivate managers to act in the **best interests of the overall company**. **Suboptimization** occurs when managers do not act in the best interests of the overall company or even their own divisions.

*Helpful Hint: Emphasize that a good transfer price is one that induces division managers to do whatever is in the best interest of the entire company. Students often take for granted that divisions should make all purchases internally whenever possible – which of course is not the case. They also sometimes lose sight of the purpose of transfer pricing in their zeal to be “fair” to the various divisions.*

iii. There are **three primary approaches** to setting transfer prices, namely negotiated transfer prices, transfers at the cost to the selling division, and transfers at market price.

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B. **Negotiated transfer prices**

*Learning Objective 5: Determine the range, if any, within which a negotiated transfer price should fall.*

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i. A **negotiated transfer price** results from discussions between the selling and buying divisions.

1. Negotiated transfer prices have **two advantages**:

a. They **preserve the autonomy** of the divisions, which is consistent with the spirit of decentralization.

b. The managers negotiating the transfer price are likely to have much **better information** about the potential costs and benefits of the transfer than others in the company.

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2. The **range of acceptable transfer prices** is the range of transfer prices within which the profits of both divisions participating in the transfer would increase.

a. The **lower limit** is determined by the selling division.

b. The **upper limit** is determined by the buying division.

ii.  **Grocery Storehouse– an example**

1. Assume the information as shown with respect to West Coast Plantations (WCP) and Grocery Mart (both companies are owned by Grocery Storehouse).

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a. The selling division’s (WCP) **lowest acceptable transfer price** is calculated as shown.

b. The buying division’s (Grocery Mart) **highest acceptable transfer price** is calculated as shown.

1. If Grocery Mart had no outside supplier for oranges, then its highest acceptable transfer price would be equal to the amount it expects to earn by selling the oranges, net of its own expenses.

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c. Let’s calculate the lowest and highest acceptable transfer prices under three scenarios.

2. If WCP **has sufficient idle capacity** (**3,000 crates**) to satisfy Grocery Mart’s demands (**1,000 crates**) without sacrificing sales to other customers, then the lowest and highest possible transfer prices are computed as follows:

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a. The **lowest** acceptable transfer price, as determined by the seller, is **$10**.

b. The **highest** acceptable transfer price, as determined by the buyer, is **$20**.

c. Therefore, **the** **range of acceptable transfer prices is $10-$20**.

3. If WCP **has no idle capacity** and must sacrifice other customer orders (**1,000 crates**) to meet the demands of Grocery Mart (**1,000 crates**), then the lowest and highest possible transfer prices are computed as follows:

a. The lowest acceptable transfer price, as determined by the seller, is **$25**.

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b. The **highest** acceptable transfer price, as determined by the buyer, is **$20**.

c. Therefore, there is **no** **range of acceptable transfer prices.**

d. This is a desirable outcome for Grocery Storehouse because it would be illogical to give up sales of **$25** to save costs of **$20**.

4. If WCP **has some idle capacity** (**500 crates**) and must sacrifice other customer orders (**500 crates**) to meet the demands of Grocery Mart (**1,000 crates**), then the lowest and highest possible transfer prices are computed as follows:

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a. The **lowest** acceptable transfer price, as determined by the seller, is **$17.50**.

b. The **highest** acceptable transfer price, as determined by the buyer, is **$20**.

c. Therefore, the **range of acceptable transfer prices** is **$17.50-$20**.

iii. **Evaluation of negotiated transfer prices**

1. If a transfer within the company would result in higher overall profits for the company, there is **always** a range of transfer prices within which both the selling and buying divisions would have higher profits if they agree to the transfer.

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2. Nonetheless, if managers are pitted against each other rather than against their past performance or reasonable benchmarks, a **noncooperative atmosphere** is almost guaranteed. Thus, negotiations often break down even though it would be in both parties’ best interests to agree to a transfer price.

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3. Given the disputes that often accompany the negotiation process, **most companies rely on some other means of setting transfer prices**.

C. **Transfers at the cost to the selling division**

i. Many companies set transfer prices at either the **variable cost or full (absorption) cost** incurred by the selling division. The drawbacks of this approach include:

1. Using full cost as a transfer price can lead to **suboptimization** because it does not distinguish between variable costs, which may be relevant to the transfer pricing decision, and fixed costs, which may be irrelevant.

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2. If cost is used as the transfer price, **the selling division will never show a profit on any internal transfer**. The only division that shows a profit is the division that makes the final sale to an outside party.

3. Cost-based transfer prices **do not provide incentives to control costs**. If the actual costs of one division are passed on to the next, there is little incentive for anyone to work on reducing costs.

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D. **Transfers at market price**

i. A **market price** (i.e., the price charged for an item on the open market) is often regarded as the best approach to the transfer pricing problem. A market-based transfer price:

1. **Works best when** the product or service is sold in its present form to outside customers and the selling division has no idle capacity.

a. With no idle capacity the real cost of the transfer from the company’s perspective is the opportunity cost of the lost revenue on the outside sale.

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2. **Does not work well when** the selling division has idle capacity. In this case, market-based transfer prices are likely to be higher than the variable cost per unit of the selling division. Consequently, the buying division may make pricing and other decisions based on incorrect, market-based cost information rather than the true variable cost incurred by the company as a whole.

E. **Divisional autonomy and suboptimization**

i. The principles of decentralization suggest that companies should grant managers **autonomy** to set transfer prices and to decide whether to sell internally or externally.

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ii. While subordinate managers may occasionally make suboptimal decisions, **top managers should allow their subordinates to control their own destiny** – even to the extent of granting subordinate managers the right to make mistakes.

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