TRANSFER PRICING

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INTRODUCTION–TRANSFER PRICE

The price at which divisions of a company transact with each other. Transactions may includes the trade of supplies or labour between departments. Transfer prices are used when Individual entities of a larger multi entry firm are treated and measured as separately run entities.

DEFINITION-TRANSFER PRICING

Transfer pricing is the setting of the price for goods and services sold between related legal entities with an enterprise.

E.g.: If a Subsidiary Company sells goods to a parent company , the cost of those goods is the transfer price.

KEY ISSUES-TRANSFER PRICING

Revenue basis

Preferred Customers

Preferred suppliers

- **Revenue Basis** : The Manager of a subsidiary treats its same manner that he would price of a product sold outside of the company. It forms part of the revenue of his subsidiary, and is therefore crucial to the financial performance on which he is judged .

- **Preferred Customers** : If the Manager of a subsidiary is given the choice of selling either to a downstream subsidiary or to outside customers, then an excessively low transfer price will lead the manager to sell exclusively to outside customers, and to refuse orders originating from the downstream subsidiary.

- **Preferred Suppliers :** If the manager of a downstream subsidiary is given the choice of buying either from an upstream subsidiary or an outside supplier, then an excessively high transfer price will cause the manager to buy exclusively from outside suppliers. As a result, the upstream subsidiary may have too much unused capacity, and will have to cut back on its expenses in order to remain profitable.

METHODS – TRANSFER PRICING

- Market Rate
- Adjusted Market rate
- Negotiated
- Contribution Margin
- Cost – Plus
- Cost Based

- **Market Rate Transfer pricing :** The simplest and most elegant transfer price is to use the market price. By doing so, the upstream subsidiary can sell either internally or externally and earn the same profit with either option. It can also earn the highest possible profit, rather than being subject to the odd profit vagaries that can occur under mandated pricing schemes.

- **Adjusted Market Rate Transfer Pricing :** If it is not possible to use the market pricing technique just noted, then consider using the general concept, but incorporating some adjustments to the price. For example, you can reduce the market price to account for the presumed absence of bad debts, since corporate management will likely intervene and force a payment if there is a risk of non-payment

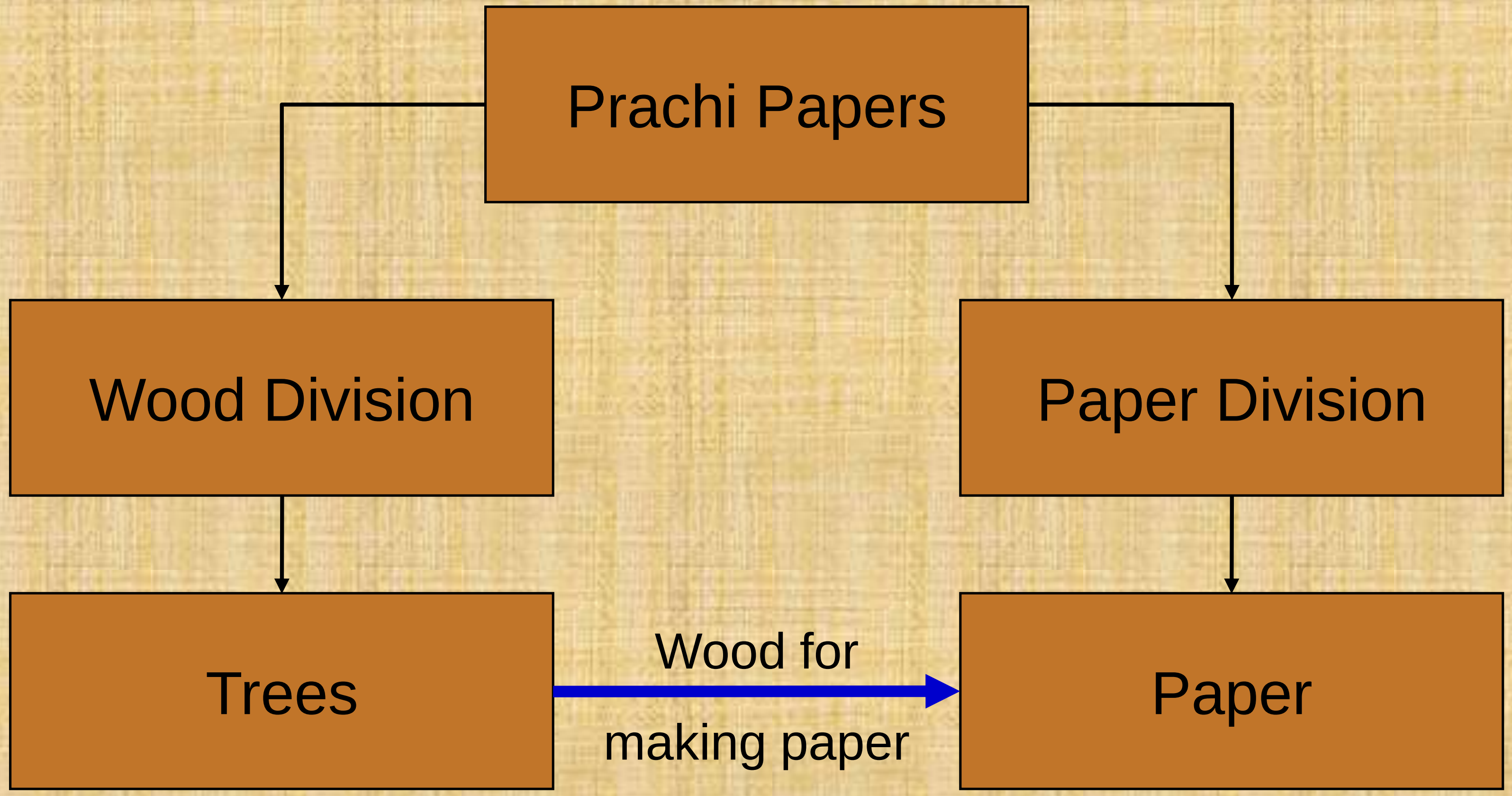
- **Negotiated Transfer Pricing :** It may be necessary to negotiate a transfer price between subsidiaries, without using any market price as a baseline. This situation arises when there is no discernible market price because the market is very small or the goods are highly customized. This results in prices that are based on the relative negotiating skills of the parties.

- **Contribution margin Transfer Pricing :** If there is no market price at all from which to derive a transfer price, then an alternative is to create a price based on a component's contribution Margin.

- **Cost plus Transfer Pricing:** If there is no market price at all on which to base a transfer price, you could consider using a system that creates a transfer price based on the cost of the components being transferred. The best way to do this is to add a margin onto the cost, where you compile the standard cost of a component, add a standard profit margin, and use the result as the transfer price.

- **Cost Based Transfer Pricing :** You can have each subsidiary transfer its products to other subsidiaries at cost, after which successive subsidiaries add their costs to the product. This means that the final subsidiary that sells the completed goods to a third party will recognize the entire profit associated with the product.

EXAMPLES – TRANSFER PRICING



PRACHI PAPERS
COST AND PRODUCTION DATA

Average units produced	100,000	
Average units sold		100,000
Variable manufacturing cost per unit	$ 20	
Variable finishing cost per unit		$ 30
Fixed divisional cost (unavoidable)	$2,000,000	$4,000,000

THE SETTING

Prachi Papers – Resources Flow

Wood Division
(selling division)
Variable cost = $20
Fixed cost = $2,000,000

Wood

Transfer price

Paper Division
(buying division)
Variable wood cost = ?
Variable finishing cost = $30
Fixed cost = $4,000,000

Market for wood
(intermediate market
Price = ?

Market for paper
(final market
Price = ?

- **Assume the following data for the wood division:**

Capacity in units		100,000
Selling price to outside	$	60
Variable price per unit	$	20
Fixed price per unit (based on capacity)	$	20

- The Paper Division is currently purchasing 100,000 units from an outside supplier for $50, but would like to purchase units from the Wood Division.

$$\text{Transfer price} = \text{Variable cost (VC)} + \text{Lost contribution margin (CM)}$$

If the Wood Division is working at capacity:

$$\text{Transfer price} = \$20 + \$40$$

If the Wood Division has idle capacity:

$$\text{Transfer price} = \$20 + \$0$$

OPTIMAL TRANSFER PRICE

- There is no intermediate market.
- In this case, the only outlet for the Wood Division is the Paper Division and the only source of supply for the Paper Division is the Wood Division.
- The optimal transfer price is the outlay cost for producing the goods (generally the variable costs).

PERFECT INTERMEDIATE MARKED-QUALITY DIFFERENCES

Variable manufacturing cost (Wood Division) per unit	$ 20
Variable finishing cost (Paper Division) per unit	$ 30
Other data:	
Final market (paper) price	$120
Intermediate market (grade A wood) price	$ 60
Intermediate market (grade B wood) price	$ 50

MANAGERS' GOALS VERSUS FIRMS' GOALS

- Transfer price higher than market: Buying division will not buy

- Transfer price lower than market: Selling division will not sell

MULTINATIONAL TRANSFER PRICING

- International (or interstate) transfer pricing can affect tax liabilities, royalties, and other payments due to different laws in different countries or states.

- Company incentive:
  – Increase profit in low-tax country
  – Decrease profit in high-tax country

THANK YOU