Preface to the Notes

This notes has been prepared for the benefit and use of CA Final students. Other Professional Course students can also use the material for respective topics of their syllabus. Being notes, the topics have been condensed and are presented in a synopsis manner. Yet, they cover the complete issues involved in respective topics and give the reader good understanding of the subject. This has been prepared for the ease of students preparing for Examinations. The issues have been explained in simple language supported by examples as well. If students desire to have more in-depth knowledge on any topic(s) then they need to refer relevant Text Books.

This paper of the CA Final course had substantial change in the contents and syllabus as compared to the erstwhile Advanced Management Accounting. There is a marked shift from more of the earlier Figure Work to Theory and Figure work in current syllabus. The syllabus has included more of the practical aspects of Management Accounting and Performance Evaluation with Case Studies. To answer practical cases, a student needs to have:

- Thorough understanding of the Theory;
- Application of theoretical knowledge to Practical business scenarios for solutions: and
- Figure work analysis.

In this part, only theory has been considered.

I hope this notes will be of good use to students.

Readers are requested to mail suggestions and feed back to ram_pv@rocketmail.com for improving the contents.

Good wishes and Happy Reading
P V Ram

CHAPTER 9: Divisional Transfer Pricing

Broad Contents of the Chapter are:

1. Brief introduction of the Concept.
2. Methods of Transfer Pricing.
3. Transfer Pricing under Different Circumstances.
4. Proposals for Resolving Transfer Pricing Conflict.
5. International Transfer Pricing.

Brief Introduction of the Concept

In the Business environment, most of the organisations are operating on Decentralised basis and Delegation is becoming the order of the day. This is paving the way for creation of Divisions and evaluating each of the divisions independently. Divisional Mangers are being made responsible for Costs or Revenues or Both for their respective Divisions. This is happening within a Company or among different companies of the same Group. Inter Division transfer could involve Goods or Services or Both. At times it can be assets also. Once Divisional Managers are made responsible for the results of their respective Divisions, then there could be issues when in some scenarios adopting a particular course of action would be in the best interest of the Division but when viewed for the Company as a whole (or Group) it may not be so. Divisional interests may not sync with Strategic Interests of the Corporate. This requires the involvement of the Top Management to advise about the course of action to be followed and this lead to the concept of Goal Congruence (i.e. integrating the objectives of the Division with Corporate Strategic Objectives.)

Advantages of Transfer Pricing:

a. **Performance evaluation**: Individual Division's or Manager's performance can be analysed to take Quick corrective actions.
b. **Employee engagement and Compensation**: To frame incentive Schemes.
c. **Resource Allocation**: To improve overall efficiency of the Company (or Group) as a whole.
d. **Taxation Angle**: To minimise cash outflow in the form of Taxes through efficient tax planning.

Methods of Transfer Pricing

A. **Market based**: This is very simple easy to comply with. The price of same or similar product in the market after adjusting for Selling Expenses is adopted as Transfer Price.
   Advantages:
   a. Since Market price depends on Demand & Supply, the price

derived will be unbiased.
b. Difficult to Manipulate Market Prices.
c. Price will be more competitive, thereby making Divisional prices more objective.

Disadvantages:

a. Market Prices may not be completely unbiased, more so when competitive environment does not exist like distress sale etc.
b. May not be suitable when Market Prices fluctuate widely.
c. Market Prices may not be available for all products, especially in case of semi finished products.

B. **Profit Shared on the basis of Respective Costs**: Profit is apportioned on the basis of Cost of respective divisions. This presumes value addition is proportional to cost incurred, which may not be in several cases.

C. **Cost Based Transfer Price**: This is based on the company's own cost records. The costs adopted may be Total Cost, Variable Cost, Standard Cost or other similar variants of Cost. However, the Cost itself being Subjective, it has to be adopted based on the suitability of the Firm.

Advantages:

a. Performance can be Benchmarked to internal Cost Targets.
b. Information is more easily available as compared to Market Price.

Disadvantages:

a. The Cost on which Transfer Price is based is a subjective one since there are several variants in cost like Total Cost, Marginal Cost etc.
b. Since Transfer Price is based on cost, Divisional Mangers have little interest for cost reduction as cost reduction involves less profit also.

D. **Negotiation based Transfer Price**: This is via media method between Market Based and Cost based Transfer Prices. In this case, Mangers are given freedom to buy from Sister Concern or from Outside Market. This requires the Internal Cost Information and also External Price information for Negotiation.

The Negotiations act as integrating tool and thereby promotes Goal Congruence through efficient performance of respective Divisions. Further, in case of sub optimal utilisation of resources, involvement of Top Management may be necessitated. Negotiated price depends on the ability of Managers to negotiate which could affect the performance of the Division and also Goal Congruence.

Transfer Pricing under Different Circumstances

A. When the Supplying Division has Excess Capacity:

Minimum Transfer Price = Marginal Cost

Maximum Transfer Price = Lower of Net Marginal Revenue and External Purchase Price.

B. When Supplying Division operates at Full Capacity:
   Minimum Transfer Price = Marginal Cost + Opportunity Cost
   Maximum Transfer Price = Lower of Net Marginal Revenue and External Purchase Price.
C. When the supplying Division operates at Different Demand Levels: There may be cases when the Division has both Internal and External Markets for its Products. Further, there may be special orders also. This may necessitate the Division to operate at different levels. Significant variations in capacity may also lead to change in Fixed Costs which may behave as semi variable costs. Economies of scale may also come into play. There may some cost savings in case of internal transfers like sales expenses, packaging, freight etc.
   So, while catering to different levels of Demand, any change in cost will lead to consequent change in Transfer Price. Minimum and Maximum Transfer Price will be as per General Rule as indicated in (A) and (B) above.

<u>Proposals for Resolving Transfer Pricing Conflict</u>

Very often there will be situations where there may be conflict among Divisions and / or the Firm as a whole by adopting a particular course of action. That is a particular course of action may be profitable to one division and may not be to the other or it may be against the Goal Congruence. In such cases, the following methods may be adopted:

A. **Dual Rate Transfer Pricing**: The Supplying Division adopts Transfer Price at its cost plus normal Profit Margin whereas the Receiving Division records the same transaction at Marginal Cost only.
   This allows for better evaluation of each Division and also promotes harmony among Divisional Managers and will be in line with Goal Congruence.
   However, this method complicates records and may result in errors. Also, profits shown by Divisions are artificial and need to be eliminated at the time of Finalisation.
B. **Two Part Transfer Pricing**: In this case the Transfer Price will be fixed in 2 parts. A fixed amount for every period and variable component equal to the Variable Cost. Fixed amount is towards Fixed Cost and Margin. The more a Division buys, the cost/unit of the product keeps coming down thereby increasing the profitability.

<u>International Transfer Pricing</u>

Due to the Liberalisation and Globalisation in the recent couple of decades, the business, now a days is spread across the Globe. There are many reasons for the change in the nature of Business.

a. Demand for Final Products
b. Easy availability of Raw Materials in certain Countries
c. Availability low cost labour with specialised skills etc.

It may be noted that many countries have regulations to cover international transactions and India is no exception. Adoption of arm's length price is a basic requirement. Following issues are looked into while fixing International Transfer Price:

a. Provisions regarding repatriation of profits
b. Economic and Political Stability of the countries
c. Tax rates on profits; More profits are shown in countries where tax rates are low and vice versa.
d. Volatility of Exchange rates
e. Macro economic factors like GDP, Inflation, Balance of Payments position, Interest rates, Population etc.