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Internal Transfer Price at Production Enterprises

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ABSTRACT:

Transfer prices are not only an accounting tool but also a tool to help managers make the right decisions, contributing to unifying the operating goals between the corporation or group and its member units. and measuring profit center performance. There is no one transfer pricing method that is best for all situations, because the best transfer pricing method for a business depends on the characteristics and internal transfer purposes of that company. The article mentions three methods of determining internal transfer prices: internal transfer prices based on costs, internal transfer prices based on negotiation, and internal transfer prices based on market prices.

Keywords: transfer pricing, manufacturing enterprises

1. Decentralized management and delegation of authority

Hierarchical management structure

Management hierarchy is the process of delegating decision-making authority from the top down through an organization's structural levels, a phenomenon that originated from the development and use of initial internal financial control tools in the early years of the 20th century. To tackle the ever-increasing competitive pressures, many corporations that were once considered stable are now changing their organizational structures and business approaches. This shift is essential, as they need to become more agile in a world where technology, customer preferences, and competitors' strategies are constantly evolving. The ability to adapt requires senior management to delegate or decentralize decision-making to more individuals within the organization. Decentralized management empowers dynamic and well-trained organizational members to quickly identify shifts in customer preferences and grants those with the most responsibility the authority and accountability to develop plans to address these changes.

Management decentralization can be implemented broadly or narrowly, depending on various factors. Narrow decentralization has the advantage of tight supervision and control over subordinate activities, but it also has some drawbacks, such as the risk of upper levels meddling too deeply in lower-level affairs, increased costs due to multiple management layers, and a significant gap between the highest and lowest levels. Broad decentralization is less costly due to fewer management levels and a shorter distance between the top and bottom tiers within the organization, but it also comes with its own set of challenges, like the potential for upper-level overload leading to decision bottlenecks and the risk of becoming uncontrollable, requiring competent managers.

Delegation

Delegation is the distribution of authority to lower management levels within a hierarchical management system. It's an inevitable phenomenon when an organization reaches a certain scale and level of development, making it impossible for one person or management level to handle all administrative tasks. A decentralized organization allows department managers to make independent decisions without needing approval from higher-ups. This brings numerous benefits to the organization. Since department managers are closer to the local environment and economic conditions, they are in a better position to assess situations and make wise decisions for their departments, maximizing both their own benefits and those of the entire organization. Moreover, in a decentralized structure, base-level and middle managers have opportunities to develop and practice their responsibility skills. Thus, delegation creates an excellent training ground for future top managers. Additionally, job satisfaction for base-level and middle managers is boosted as they control their domain and take pride in ownership.

Factors that determine the level of decentralization:

- The greater the cost of a decision, the higher the level it demands to be made, and vice versa. Therefore, this is the most crucial factor in determining the degree of decentralization.
- The need for policy consistency: if uniformity isn't required, lower levels can be flexible (meaning strong decentralization); otherwise, it leads to reduced decentralization and increased centralization.

- The larger the company, the more decisions need to be made and the more positions that need to be established, making coordination increasingly complex. Therefore, in large organizations, it's necessary to delegate authority to essential departments where possible.
- The proficiency of grassroots-level managers.

2. The valuation of internally transferred products in relation to the organizational management structure.

Various management and organizational models.

To manage and operate all activities within an organization, a structure comprising various levels, links, and interconnected departments is essential, arranged both vertically and horizontally. This organizational structure is a composite of different parts with interdependent relationships. Specialized with defined responsibilities and authorities, these components are organized across various levels to ensure the execution of management functions and serve the company's established common goals, including functional management structures, strategic business unit structures, and matrix management models. As companies grow in size and complexity, they tend to evolve towards a decentralized organization consisting of interacting segments characterized by autonomous profit centers. In a survey of the largest manufacturing companies in the US, 98.5% were organized as multi-profit centers. Similarly, Vancil's (1978) study found that out of 313 surveyed manufacturing enterprises, 296 (about 95%) had two or more profit centers. In such cases, corporate headquarters face the challenge of ensuring congruent objectives—that is, making sure that division managers' actions align with the overall interests of the company. This issue is particularly challenging for vertically integrated companies where one department provides goods or services to another within the same organization.

At every management level of the company, working swiftly and effectively requires providing reliable and updated information for decision-making, involving experts with authority on the company's professional and strategic issues in the decision-making process, and their response to the dynamic environment in the shortest possible reaction time. To achieve this, in a decentralized company, departments are formed based on activities where individuals are accountable for the outcomes that influence their decisions. As a result, depending on how their autonomous decisions, or how they affect outcomes, affect the necessary input factors for their operations and the nature of their output results, these units' independence and the scope of their responsibilities can vary. It is absolutely essential to review the company's organizational structure if we talk about transfer pricing, because transfer pricing can only be utilized if an appropriate method of accountability is properly in place. Nowadays, this issue is becoming increasingly significant.

3. The concept and role of internal transfer pricing in a company.

The concept of internal transfer pricing.

Eccles, R.G. (1985), transfer pricing refers to the price applied to goods, services, and assets transferred within a company's internal divisions as they move from one organizational entity (a department or unit) to another. Thus, while the role of external sales prices is to efficiently allocate resources in the market, the role of transfer pricing is to effectively allocate resources within the company.

Vaysam Igor in 1996, in decentralized organizations, goods and services are transferred between departments. When a product made by one part of the company is passed on to another, these transactions are usually recorded in the accounting books of the involved departments; production units typically log an internal revenue, while purchasing departments record an internal cost. The amount referred to in these internal transactions is known as the transfer price. Thus, when managers are evaluated based on the accounting income of their units, the transfer price influences their management decisions.

Horngren and Foster (2012) describe the price set for a product or service provided by one department to another within the same organization as a transfer price. Pricing goods or services between departments in the same organization and within the same country is known as domestic transfer pricing.

The role of internal transfer pricing in business

Otley (1994) regards transfer pricing as a tool to maintain cohesion among activities and preserve organizational capability for companies to survive in uncertain environments. A transfer pricing system is deemed essential for the optimal allocation of resources within a company and provides appropriate measures for assessing divisional profitability. Through evaluating business efficiency, this information is used to decide where to buy from and sell to, informing other decisions such as whether to continue or discontinue a product or service, expand or downsize divisions, and promote or dismiss managers. These decisions affect resource allocation within the company. Transfer pricing measures effectiveness, evaluates and rewards performance, and influences individual managers' perceptions of fairness. If the underlying basis for transfer pricing is flawed, subsequent decisions related to resource allocation are likely to be flawed as well, potentially leading to the closure of efficient departments while expanding less effective ones.

Nguyễn Thị Phương Hoa (2011), transfer pricing not only influences the output and input decisions of each member but also affects the profits of individual units and the company as a whole. Therefore, internal transfer pricing is not just an accounting tool but also aids managers in making sound decisions. Transfer prices should be designed to achieve various objectives, including: Managers at different levels within a company aim to reach different goals through transfer pricing policies. Senior managers want transfer prices to encourage department managers to make decisions that maximize the company's overall profits. In contrast, department managers desire transfer prices that accurately reflect their division's financial health and showcase sound business decisions.

Internal transfer pricing methods.

Transfer pricing is based on cost.

With this method, the transfer price can be calculated using the actual cost, normal cost, standard cost (predetermined cost), direct cost (variable cost), total cost (full cost), or total cost plus a markup.

Transfer pricing is based on actual costs (Actual Costing Transfer Pricing, or ACTP).

The actual costing method determines the product's production costs based on the actual incurred costs of materials, labor, and manufacturing overhead allocated to the finished product volume.

Transfer pricing for the product = equals Cost of product implementation

In any cost allocation method, the main advantage of using transfer pricing over actual costs is its ease of implementation, given the availability of actual costs and corresponding factors from accounting records. However, pricing transfer products based on actual costs often comes with limitations, such as leading to misguided decisions because it doesn't clearly indicate when transfers are most beneficial and how they affect overall corporate profits. Using actual costs as the basis for product transfer pricing doesn't encourage production departments to control costs better. This is because all incurred costs, whether efficient or wasteful, are passed on to the department utilizing the transferred products. Consequently, only the final consumer department—the one selling products to external customers—calculates profit and loss results. Therefore, managers might mistakenly attribute success solely to this final stage, overlooking that it's not just the last step that determines the outcome of business operations.

Transfer pricing is based on standard pricing.

Standard cost is the expense to produce or supply a unit of goods or services according to technical design. Standard costs are often based on estimated figures established by the department responsible for production before manufacturing takes place. These standard costs are used as a basis for deciding the quantity of goods to be produced. Since transfer pricing is based on standard costs, it's expected that the production department will be motivated to continue reducing actual costs—to encourage sellers to produce efficiently, transfer prices should rely on standards rather than actual expenses.

Pros: The calculation method is straightforward and easy to apply for transfer units, minimizing waste in departments with transferable products and encouraging cost savings across the entire company.

Downside: The standard costs used for transfer pricing can quickly become outdated as market conditions, production, and technology evolve. For instance, if market prices for raw materials rise, the standard cost of raw materials in a transferred product unit may end up being lower than the actual cost. Similarly, technological advancements could render the current standard costs for materials or labor excessively high. Therefore, when using standard costing, businesses need strategies to ensure that their costing methods remain true to reality and that adjustments to standard costs keep pace with changing conditions.

Transfer pricing is based on variable costs (marginal costs).

Costs calculated by this method include various variable expenses such as raw material costs, labor costs, general production costs, and administrative and sales variable costs.

The advantage of this costing approach is its simplicity, allowing decisions to be made based on marginal costs.

Drawback: It doesn't encourage sellers to manage overall costs effectively or buyers to seek better suppliers, as variable costs can fluctuate across different production levels due to economies of scale in manufacturing, potentially limiting company profits when the sales department operates at maximum capacity and is forced to sell to the purchasing department. The sales department might refuse internal sales in favor of external ones at prices that include overhead and profit, possibly leading the purchasing department to estimate lower selling prices. Setting transfer prices based on variable costs could prompt the production department to inflate variable costs by allocating fixed costs to them.

Transfer pricing is based on the full cost plus an added profit margin.

According to the full-costing method (full cost plus a markup), it includes direct material costs, direct labor costs, and allocated overhead. Transfer pricing based on full cost or full cost with an added markup is quite widely used in practice. The appeal of these two methods is that they enable managers to treat product-related decisions as long-term choices.

Advantage: It allows the seller to account for all costs and cover expenses, creating pressure on the buyer's management to implement measures that enhance efficiency due to the high input costs.

This costing method can be inaccurate in allocating internal costs, as the seller's fixed costs become variable costs for the buyer, potentially leading to decisions that affect the overall profitability of the business.

Pricing transfer products at market value.

If an external market exists for intermediary products and services, the market price is the most suitable basis for pricing products or services transferred between responsibility centers. The market price provides an independent assessment of the transferred products and services, as well as how much each profit center contributes to the total profit the company earns from these transactions. For example, instead of transferring goods internally, a sales department could sell the goods externally. Similarly, a purchasing department might buy from outside sources rather than through internal transfers. When a market-based transfer price for an intermediary product exists, it optimally serves both decision-making purposes and business performance evaluation to establish transfer pricing at competitive market rates. A perfectly competitive market exists when products are homogeneous and no single buyer or seller can influence the market price.

In a perfectly competitive market, the supply side should meet as many demands of the receiving department as possible at the current market price, provided that the additional costs are lower than the market price. If this supply can't fulfill the needs of the receiving members, then the supplying members must seek additional sources by purchasing from external suppliers at the current market prices. Moreover, if the supplying members produce more intermediate products than what the receiving members need, they can sell this surplus in the external market at the prevailing market rates.

One of the big challenges with using market prices is that the market often lacks perfect competition. Plus, transfer products can have unique features that set them apart from similar items. Market pricing for intermediary goods really only works when the quantity, delivery methods, discounts, and warranty services are all on the same page.

Transfer pricing is based on negotiation.

Transferring products at market prices is quite common, but with the limitations just mentioned, sometimes the transfer price can't be executed. To tackle this issue, managers often set transfer prices through negotiation. With this negotiated pricing method, the seller and buyer will discuss and agree on a price for the goods or services being transferred. Typically, expected profit plus variable costs at standard rates determine the transfer price.

The challenges encountered in establishing a reasonable transfer pricing method have led to the suggestion that negotiated transfer prices should be used. Negotiated transfer prices are most suitable in situations where market imperfections exist for intermediate products, particularly when there are differences in selling costs between internal and external transactions or when various market price levels exist. In such cases of market flaws, division managers should have the freedom to buy and sell products outside the company to enable them to engage in a negotiation process.

If members are allowed to negotiate freely among themselves, they'll typically make decisions that maximize the overall profit of the company, assuming, of course, that the managers are skilled and can effectively utilize accounting information. For negotiations to be effective, it's crucial that managers have equal bargaining power. Their negotiating power won't be equal if one party has a wide range of product or service options while the other has a limited market. Unequal bargaining power can also arise if transactions are relatively minor for one member but significant for another. The manager of the member who views the transaction as minor has a much stronger negotiating position because they won't face serious consequences if they fail to reach an agreement on the proposed internal transfers.

The advantage of pricing transfers through negotiation is that it fosters fairness in the mindset of managers involved in the transfer pricing talks. Negotiated pricing opens doors to satisfying several standards: aligning departmental goals with those of the entire company, autonomy, and appropriately assessing the performance of various departments. If the agreement ensures goal alignment, corporate leadership intervention in transfer pricing will significantly decrease. If the negotiating skills of managers in member units are similar, or if the enterprise considers these skills essential and necessary management competencies, concerns about accurate performance metrics can be avoided.

However, the actual transfer price agreed upon is subject to the following limitations:

- Because the agreed transfer price can hinge on the negotiating skills and bargaining power of the managers involved, the end result might not be close to optimal.
- These can lead to conflicts between departments, and resolving such conflicts may require the intervention of higher management, which could affect the autonomy of each unit as senior management delves into the negotiation process.
- A department's profit may hinge on the negotiation skills of its managers, even though these individuals often have disproportionate bargaining power.
- It can be quite time-consuming for the department managers involved, especially when there's a large volume of transactions to handle.

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