

ALERTING PRINCIPLES OF ACCOUNTING STUDENTS ABOUT THE ECONOMIC IMPACT OF TRANSFER PRICING ALTERNATIVES

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ABSTRACT

The economic impact of transfer pricing alternatives can be significant. However, most principles of accounting textbooks contain no coverage of the topic and, those that do, have a very limited coverage that may or may not be part of the material covered during the semester. How then can another topic be squeezed into the already overcrowded array of material in the principles of accounting curriculum? Presented in this paper is a transfer pricing problem which should blend in well with topics currently covered and allow students to quickly become aware of the existence and impact of transfer prices on the business environment.

INTRODUCTION

The economic impact of transfer pricing alternatives can be significant. However, most principles of accounting courses contain no coverage of the topic and, those that do, have a very limited coverage that may or may not be part of the material covered during the semester. How then can another topic be squeezed into the already overcrowded array of material in the principles of accounting curriculum? Presented in this paper is a transfer pricing problem which should blend in well with topics currently covered and allow students to quickly become aware of the existence and impact of transfer prices on the business environment.

OVERVIEW OF TRANSFER PRICING

Transferring goods or services between two divisions of a diversified company is frequently encountered in the workplace. Determining the price at which the transfer should be recorded can prove problematic – with the ideal being the price that fosters goal congruence whereby what is best for each separate division is also what is best for the company as a whole. Consider the following situation:

Transprice, Inc. has two divisions, A and Z. Division A has 500 pounds of Kzon that it can sell to an outside customer for \$1 per pound. Incremental selling costs of \$.15 per pound will be incurred if the Kzon is sold to the outside customer. Alternately, the 500 pounds of Kzon could be transferred to Division Z for a yet unspecified transfer price. If transferred, the incremental selling costs of \$.15 per pound will be avoided and Division Z will add additional costs of \$200 to convert the 500 pounds of Kzon into 550 pounds of XK20 that can be sold for a total price of \$800. If the Kzon is not transferred from A to Z, the XK20 will not be produced.

TRANSFER PRICING QUESTIONS AND ANSWERS

1. Q: At a transfer price of \$650, will Division A favor selling to an outsider or transferring to Division Z?

A: Sell to outsider:

Revenue.....	\$500
- Expenses 500 (\$.15)....	75
Net Income.....	<u>\$425</u>

Sell to Division Z: \$650 = Better Choice

2. Q: At a transfer price of \$650, will Division Z favor having the Kzon transferred in from Division A?

A: Make into XK20:

Revenue.....\$800

- Expenses:

Kzon.....\$650

Additional.... 200 850

Net Loss.....(\$ 50) Due to the Net Loss, Division Z would not want the transfer.

3. Q: At a transfer price of \$650, will Transprice, Inc. favor the transfer? Why or why not?

A: Division A sell to outsider = \$425

Division A sell to Division Z = \$650

Division Z make into XK20 = (\$ 50)

Net Income from transfer = \$600 = Better Choice – Transprice would favor the transfer.

4. Q: At a transfer price of \$550, will Division A favor selling to an outsider or transferring to Division Z?

A: Sell to outsider:

Revenue.....\$500

- Expenses 500 (\$.15).... 75

Net Income.....\$425

Sell to Division Z: \$550 = Better Choice

5. Q: At a transfer price of \$550, will Division Z favor having the Kzon transferred in from Division A?

A: Make into XK20:

Revenue.....\$800

- Expenses:

Kzon.....\$550

Additional..... 200 750

Net Income.....\$ 50 Yes, due to the Net Income, Division Z would want the transfer.

6. Q: At a transfer price of \$550, will Transprice, Inc. favor the transfer? Why or why not?

A: Division A sell to outsider = \$425

Division A sell to Division Z = \$550

Division Z make into XK20 = \$ 50

Net income from transfer = \$600 = Better Choice – Transprice would favor the transfer.

7. Q: What is the acceptable range of transfer prices that will foster goal congruence within the corporation?

A: Division A: Transfer price must be greater than the sell to outsider alternative of \$425.

Division Z: Transfer price must be less than: Revenue of \$800
less additional expenses of 200
Must be less than..... \$600

So, Transfer Price Range = $\geq \$425$ to $< \$600$

Accordingly, the acceptable range of transfer prices that will foster goal congruence includes prices that are above \$425 and below \$600.

ANALYSIS OF THE PROBLEM

Goal congruence is found between \$425 and \$600. At any point on this continuum, Division A, Division Z and Transprice, Inc. all benefit. However, students need to be alerted to several problems. With large diversified companies and autonomous divisions, it is often difficult to isolate numbers like the ones used in the problem above in one upper-level management location in the company and still maintain division autonomy. Additionally, it is not unusual for a transfer from one division to another to present a situation where no market price is readily available. Even where a market price does exist, it is sometimes very difficult to accurately equalize the comparison of internal versus external market prices. For example, it is difficult to correctly weigh factors such as product quality, product delivery reliability, and product price stability. For example, if a transfer pricing situation exists and the company is at a point where it is considering a decision of whether to quit making internally and to start buying externally, it must weigh factors such as the quality of the external product, its delivery reliability and the economic supply-demand impact on the price if it stops making (reduces supply) and starts buying (increases demand) – putting a pressure on future external price increase possibilities.

SUMMARY AND CONCLUSIONS

With just a short problem similar to the one in this paper, which can even be included with other problems where net income is determined, students will be alerted to a very important situation that readily occurs in the workplace – determining transfer prices that will foster goal congruence between divisions in the same company. Alerting students to a variety of real-world workplace problems – even in the freshman and sophomore level courses – will not only make the material more interesting, it should also make it easier to learn since students will hopefully perceive an increase in the relevance of the information when it relates to real-world situations that students may encounter in their professional lives after graduation.