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Lecture-10

Responsibility Accounting and Transfer Pricing

Responsibility Accounting and Transfer Pricing

Contents

Objectives

Introduction

10.1 Responsibility Centers

    10.1.1 Cost Center

    10.1.2 Revenue Center

    10.1.3 Profit Center

    10.1.4 Investment Center

10.2 Controllability Concept

10.3 Accounting Concepts

10.4 Advantages and Disadvantages of Responsibility Accounting

10.5 Transfer Pricing

    10.5.1 Objectives of Transfer Pricing

    10.5.2 Transfer Pricing Methods

10.6 Summary

10.7 Keywords

10.8 Review Questions

10.9 Further Readings

Objectives

After studying this Chapter, you will be able to:

- Define responsibility centres
- Describe controllability and accounting concept
- Discuss the advantages and disadvantages of responsibility accounting
- Explain transfer pricing

Introduction

Responsibility accounting is an underlying concept of accounting performance measurement systems. The basic idea is that large diversified organizations are difficult, if not impossible to manage as a single segment, thus they must be decentralized or separated into manageable parts. These parts, or segments are referred to as responsibility centers that include:

1. Revenue centers,
2. Cost centers,
3. Profit centers, and
4. Investment centers

Notes

Responsibility accounting is appropriate where top management has delegated authority to make decisions. The idea behind responsibility accounting is that each manager's performance should be judged by how well he or she manages those items under his or her control. This approach allows responsibility to be assigned to the segment managers that have the greatest amount of influence over the key elements to be managed. These elements include revenue for a revenue center (a segment that mainly generates revenue with relatively little costs), costs for a cost center (a segment that generates costs, but no revenue), a measure of profitability for a profit center (a segment that generates both revenue and costs) and return on investment (ROI) for an investment center (a segment such as a division of a company where the manager controls the acquisition and utilization of assets, as well as revenue and costs).

10.1 Responsibility Centers

The concept of responsibility accounting has emerged to accommodate the need for management information at a more specific level of detail than can be provided by financial accounting procedures. Responsibility accounting attempts to report results (actual performance) in such a way that:

5. significant variances from planned performance can be identified,
6. reasons for variances can be determined,
7. responsibility can be fixed, and
8. timely action can be taken to correct problems.

Under this approach, pertinent costs and revenues are assigned to various organizational Chapters – departments, bureaus, and programs – designated as responsibility centers. A decentralized environment results in highly dispersed decision making. As a result, it is imperative to monitor and judge the effectiveness of each manager. This is easier said than done. Not all Chapters are capable of being evaluated on the same basis. Some Chapters do not generate any revenue; they only incur costs in support of some necessary function. Other Chapters that deliver goods and services have the potential to be assessed on the basis of profit generation.

As a generalization, the part of an organization under the control of a manager is termed a "responsibility center." To aid performance evaluation it is first necessary to consider the specific character of each responsibility center. Some responsibility centers are cost centers and others are profit centers. On a broader scale, some are considered to be investment centers. The logical method of assessment will differ based on the core nature of the responsibility center.

10.1.1 Cost Center

A cost center is the smallest segment of activity or area of responsibility for which costs are accumulated. Obviously most business Chapters incur costs, so this alone does not define a cost center. A cost center is perhaps better defined by what is lacking; the absence of revenue, or at least the absence of control over revenue generation.

Human resources, accounting, legal, and other administrative departments are expensive to support and do not directly contribute to revenue generation. Cost centers are also present on the factory floor. Maintenance and engineering fall into this category. Many businesses also consider the actual manufacturing process to be a cost center even though a saleable product is produced (the sales "responsibility" is shouldered by other Chapters).

It stands to reason that assessments of cost control are key in evaluating the performance of cost centers. This Chapter will show how standard costs and variance analysis can be used to pinpoint areas where performance is above or below expectation. Cost control should not be confused with cost minimization. It is easy to reduce costs to the point of destroying enterprise effectiveness.

Notes

The goal is to control costs while maintaining enterprise effectiveness.

Non-financial metrics are also useful in monitoring cost centers: documents processed, error rates, customer satisfaction surveys, and other similar measures can be used.

Example: 1. The manager for purchasing department.

2. The manager for maintenance department.

10.1.2 Revenue Center

Revenue center can be defined as a distinctly identifiable department, division, or Chapter of a firm that generates revenue through sale of goods and/or services.

Example: Rooms department and food and beverages department of a hotel.

10.1.3 Profit Center

Some business Chapters have control over both costs and revenues and are therefore evaluated on their profit outcomes. For such profit centers, "cost overruns" are expected if they are coupled with commensurate gains in revenue and profitability.

Example: A restaurant chain may evaluate each store as a separate profit center. The store manager is responsible for the store's revenues and expenses. A store with more revenue would obviously generate more food costs; an assessment of food cost alone would be foolhardy without giving consideration to the store's revenues.

Thus profit center is a segment of a business, often called a division that is responsible for both revenue and expenses. The reason been Revenue minus Cost is the Profit.

The manager is therefore overall responsible or accountable for making profit for the company.

Example: A company has many restaurants which are all profit centre. A manager is assigned to each restaurant to make sure it is a profit centre.

10.1.4 Investment Center

At higher levels within an organization, Chapter managers will be held accountable not only for cost control and profit outcomes, but also for the amount of investment capital that is deployed to achieve those outcomes. In other words, the manager is responsible for adopting strategies that generate solid returns on the capital they are entrusted to deploy. Evaluation models for investment centers become more complex and diverse. They usually revolve around various calculated rates of returns.

Thus an investment center, like a profit center, is responsible for both revenue and expenses, but also for related investments of capital.

Example: An example of an investment centre is a Corporate division responsible for project investments.

Here, the manager is responsible for the investments which includes all the revenue, costs and investments (invested capital or assets).

Outside of relatively large corporations, the cost center is the most common building block for responsibility accounting. In fact, the terms cost center and responsibility center are often used interchangeably.

Task Analyse different centers of a food chain of your choice and categorise them into various types of responsibility centers.

Self Assessment

Fill in the blanks:

9. The concept of responsibility accounting has emerged to accommodate the need for management information at a more specific level of detail than can be provided by .... procedures.

2. A .... is a Chapter within an organization that is responsible for generating revenues.

3. A .... is part of an organization that does not produce direct profit and adds to the cost of running a company.

4. .... is a Chapter within an organisation whose manager not only has profit responsibility but also some influence on capital expenditures.

5. The basic idea under responsibility accounting is that large .... organizations are difficult, if not impossible to manage as a single segment.

6. Responsibility accounting is appropriate where top management has .... authority to make decisions.

10.2 Controllability Concept

An underlying concept of responsibility accounting is referred to as controllability. Conceptually, a manager should only be held responsible for those aspects of performance that he or she can control. In my view, this concept is rarely, if ever, applied successfully in practice because of the system variation present in all systems. Attempts to apply the controllability concept produce responsibility reports where each layer of management is held responsible for all subordinate management layers. The managers thus, should take care of certain essential elements to ensure adequate responsibility accounting.

Relevance

The convention of relevance emphasizes the fact that only such information should be made available by accounting as is relevant and useful for achieving its objectives.

Example: Business is interested in knowing as to what has been total labor cost? It is not interested in knowing how much employees spend and what they save.

Objectivity

The convention of objectivity emphasizes that accounting information should be measured and expressed by the standards which are commonly acceptable.

Example: Stock of goods lying unsold at the end of the year should be valued as its cost price not at a higher price even if it is likely to be sold at higher price in future. Reason is that no one can be sure about the price which will prevail in future.

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Feasibility

The convention of feasibility emphasizes that the time, labour and cost of analyzing accounting information should be compared vis-à-vis benefit arising out of it.

Example: The cost of 'oiling and greasing' the machinery is so small that its break-up per Chapter produced will be meaningless and will amount to wastage of labor and time of the accounting staff.

Self Assessment

Fill in the blanks:

10. The convention of feasibility emphasizes that the .... , ... and .... of analyzing accounting information should be compared vis-à-vis benefit arising out of it.
11. Coventionally, a manager should only be held responsible for those aspects of performance that he or she can ....

10.3 Accounting Concepts

Responsibility accounting is based on certain concepts. They are utmost important to be followed while accounting the responsibility. A detailed discussion on each of them follows.

Materiality

It refers to the relative importance of an item or event. Those who make accounting decisions continually confront the need to make judgments regarding materiality. Is this item large enough for users of the information to be influenced by it?

The essence of the materiality concept is the omission or misstatement of an item is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying on the report would have been changed or influenced by the inclusion or correction of the item.

Accounting Period

Though accounting practice believes in continuing entity concept i.e. life of the business is perpetual but still it has to report the 'results of the activity undertaken in specific period (normally one year). Thus, accounting attempts to present the gains earned or losses suffered by the business during the period under review. Normally, it is the calendar year (1st January to 31st December) but in other cases it may be financial year (1st April to 31st March) or any other period depending upon the convenience of the business or as per the business practices in country concerned.

Due to this concept it is necessary to take into account during the accounting period, all items of revenue and expenses accruing on the date of the accounting year. The problem confronting this concept is that proper allocation should be made between capital and revenue expenditure. Otherwise the results disclosed by the financial statements will be affected.

Realization

This concept emphasizes that profit should be considered only when realized. The question is at what stage profit should be deemed to have accrued? Whether at the time of receiving the order

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or at the time of execution of the order or at the time of receiving the cash. For answering this question the accounting is in conformity with the law and recognizes the principle of law, i.e. the revenue is earned only when the goods are transferred. It means that profit is deemed to have accrued when 'property in goods passes to the buyer' viz. when sales are affected.

Matching

Though the business is a continuous affair yet its continuity is artificially split into several accounting years for determining its periodic results. This profit is the measure of the economic performance of a concern and as such it increases proprietor's equity. Since profit is an excess of revenue over expenditure it becomes necessary to bring together all revenues and expenses relating to the period under review. The realization and accrual concepts are essentially derived from the need of matching expenses with revenues earned during the accounting period. The earnings and expenses shown in an income statement must both refer to the same goods transferred or services rendered during the accounting period. The matching concept requires that expenses should be matched to the revenues of the appropriate accounting period. So we must determine the revenue earned during a particular accounting period and the expenses incurred to earn these revenues.

Entity

According to this concept, the task of measuring income and wealth is undertaken by accounting, for an identifiable Chapter or Entity. The Chapter or entity so identified is treated different and distinct from its owners or contributors. In law the distinction between owners and the business is drawn only in the case of joint stock companies but in accounting this distinction is made in the case of sole proprietor and partnership firm as well.

Example: Goods used from the stock of the business for business purposes are treated as a business expenditure but similar goods used by the proprietor, i.e. owner for his personal use are treated as his drawings.

Such distinction between the owner and the business Chapter has helped accounting in reporting profitability more objectively and fairly. It has also led to the development of "responsibility accounting" which enables us to find out the profitability of even the different sub-Chapters of the main business.

Stable Monetary Chapter

Accounting presumes that the purchasing power of monetary Chapter, say Rupee, remains the same throughout.

For example, the intrinsic worth of one Rupee is same and equal in the year 1900 and 2000 thus ignoring the effect of rising or falling purchasing power of monetary Chapter due to deflation or inflation. In spite of the fact that the assumption is unreal and the practice of ignoring changes
in the value of money is now being extensively questioned, still the alternatives suggested incorporating the changing value of money in accounting statements viz., Current Purchasing Power method (CPP) and Current Cost Accounting method (CCA) are in evolutionary stage. Therefore, for the time-being we have to be content with the 'stable monetary Chapter' concept.

Cost

This concept is closely related to the going concern concept. According to this, an asset is ordinarily recorded in the books at the price at which it was acquired, i.e. at its cost price. This 'cost' serves the basis for the accounting of this asset during the subsequent period. This 'cost' should not be confused with 'value'.

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It must be remembered that as the real worth of the assets changes from time to time, it does not mean that the value of such an asset is wrongly recorded in the books. The book value of the assets as recorded does not reflect their real value. It does not signify that the values noted therein are the values for which they can be sold. Though the assets are recorded in the books at cost, in course of time, they become reduced in value on account of depreciation charges. In certain cases, only the assets like 'goodwill' when paid for will appear in the books at cost and when nothing is paid for, it will not appear even though this asset exists on name and fame created by a concern.

Therefore, the values attached to the assets in the balance sheet and the net income as shown in the Profit and Loss account cannot be said to reflect the correct measurement of the financial position of an undertaking, as they do not have any relation to the market value of the assets or their replacement values. This idea that the transactions should be recorded at cost rather than at a subjective or arbitrary value is known as Cost Concept. With the passage of time, the market value of fixed assets like land and buildings vary greatly from their cost.

These changes or variations in the value are generally ignored by the accountants and they continue to value them in the balance sheet at historical cost. The principle of valuing the fixed assets at their cost and not at market value is the underlying principle in cost concept. According to them, the current values alone will fairly represent the cost to the entity.

The cost principle is based on the principle of objectivity. The supporters of this method argue so long as the users of the financial statements have confidence in the statements, there is no necessity to change this method.

Conservatism

This concept emphasizes that profit should never be overstated or anticipated. Traditionally, accounting follows the rule "anticipate no profit and provide for all possible losses.

Example: The closing stock is valued at cost price or market price, whichever is lower.

The effect of the above is that in case market price has come down then provide for the 'anticipated loss' but if the market price has gone up then ignore the 'anticipated profits'.

Critics point out that conservation to an excess degree will result in the creation of secret reserve. This will be quite contrary to the doctrine of disclosure. However, conservatism to a reasonable degree may not come in for criticism.

Self Assessment

Fill in the blanks:

12. Though the assets are recorded in the books at cost, in course of time, they become reduced in value on account of .... charges.
13. Conservation to an excess degree will result in the creation of ....
14. Responsibility accounting provides a way to .... lower level managers and workers.

10.4 Advantages and Disadvantages of Responsibility Accounting

Responsibility accounting has been an accepted part of traditional accounting control systems for many years because it provides an organization with a number of advantages. Perhaps the most compelling argument for the responsibility accounting approach is that it provides a way to manage an organization that would otherwise be unmanageable.

1. In addition, assigning responsibility to lower level managers allows higher level managers to pursue other activities such as long term planning and policy making.
15. It also provides a way to motivate lower level managers and workers.
16. Managers and workers in an individualistic system tend to be motivated by measurements that emphasize their individual performances.

However, this emphasis on the performance of individuals and individual segments creates what some critics refer to as the "stovepipe organization." Others have used the term "functional silos" to describe the same idea.

17. Information flows vertically, rather than horizontally.
18. Individuals in the various segments and functional areas are separated and tend to ignore the interdependencies within the organization.
19. Segment managers and individual workers within segments tend to compete to optimize their own performance measurements rather than working together to optimize the performance of the system.

Thus it can be said that an implicit assumption of responsibility accounting is that separating a company into responsibility centers that are controlled in a top down manner is the way to optimize the system. However, this separation inevitably fails to consider many of the interdependencies within the organization. Ignoring the interdependencies prevents teamwork and creates the need for buffers such as additional inventory, workers, managers and capacity. Of course, a system that prevents teamwork and creates excess is inconsistent with the lean enterprise concepts of just-in-time and the theory of constraints. For this reason, critics of traditional accounting control systems advocate managing the system as a whole to eliminate the need for buffers and excess. They also argue that companies need to develop process oriented learning support systems, not financial results, fear oriented control systems. The information system needs to reveal the company's problems and constraints in a timely manner and at a disaggregated level so that empowered users can identify how to correct problems, remove constraints and improve the process. According to these critics, accounting control information does not qualify in any of these categories because it is not timely, disaggregated, or user friendly.

This harsh criticism of accounting control information leads us to a very important controversial question. Can a company successfully implement just-in-time and other continuous improvement concepts while retaining a traditional responsibility accounting control system? Although the jury is still out on this question, a number of field research studies indicate that accounting based controls are playing a decreasing role in companies that adopt the lean enterprise concepts. In a recent study involving nine companies, each company answered this controversial question in a different way by using a different mix of process oriented versus results oriented learning and control information. Since each company is different, a generalized answer to this question for all firms in all situations cannot be provided.

Case Study

Out to Lunch Cuisine Inc.

Out to Lunch was established in Vancouver, Canada, in 1985. It is a rapidly growing fast-food restaurant chain.

Their business model revolves around a uniquely flavored hamburger, and a very simple menu consisting of a hamburger, fries, and drinks. They provide simple "round number" pricing, few products, and rapid service. Out to Lunch also has a catering service for sporting events, corporate outings, and similar occasions.

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Refer to the chart below to understand the working of OTL Cuisine Inc. The blocks in the organization chart indicate the character of performance/responsibility evaluation that is germane to each position. The Chief Executive Officer reports to the owners, and the owners are primarily interested in their return on investment. Three vice presidents report to the CEO:

20. The VP of operations is responsible for the overall investment in operations, which is driven heavily by the combined profits of each store. The VP of Operations oversees procurement, store management, and catering management.

    The Procurement Manager oversees purchasing of food and dishware.

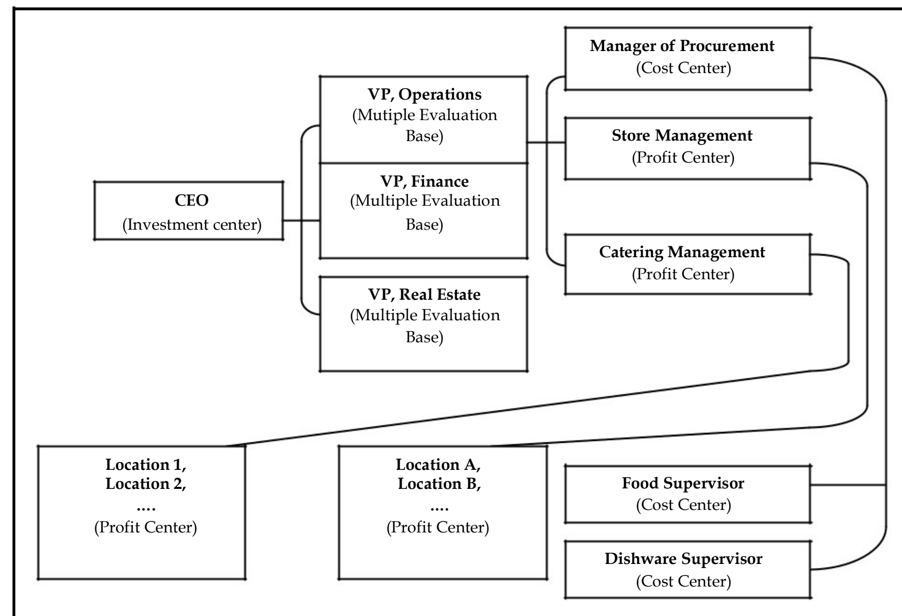
    The Procurement activities are evaluated as cost centers, relying on budgets and standard costs to control activities.

    The Store and Catering managers oversee supervisors from each location.

    The Store and Catering Managers are responsible for producing profits, and are evaluated accordingly.

21. The VP of Finance is viewed and evaluated as a cost center.

22. The VP of Real Estate is responsible for site acquisition and construction. Although the activities are largely viewed in the context of a cost center, there is an expected rate of return for each new real estate investment. Therefore, the VP of Real Estate is evaluated for cost control and return on investments.



The accounting system of the company supports preparation of an accounting report for each responsibility center. This information is essential to monitor, control, and direct each business Chapter. Each individual store has a customized performance report. Often, the reports provide a comparison between budgeted and actual data, with the difference being reported as a variance from budget. These performance reports are consistent with the organizational structure of the firm. At successively higher levels within the organization, the reports tend to include less transaction specific detail and more combinations of business Chapters.

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PERFORMANCE REPORT
STORE LOCATION A
FOR THE YEAR ENDING DECEMBER 31, 20X5

	ACTUAL RESULTS		BUDGETED RESULTS		VARIANCE
	PERCENT OF SALES	Totals	PERCENT OF SALES	Totals	
Sales:					
Burgers	40%	$ 1,000,000	43%	$ 1,100,000	$ (100,000)
Fries	24%	600,000	22%	550,000	50,000
Drinks	36%	900,000	35%	875,000	25,000
Total Sales	100%	$ 2,500,000	100%	$ 2,525,000	$ (25,000)
Less: Variable Expenses					
Food cost	19%	$ 475,000	20%	$ 505,000	$ (30,000)
Other variable expenses	7%	175,000	8%	200,000	(25,000)
Total Variable Expenses	26%	$ 650,000	28%	$ 705,000	$ (55,000)
Contribution Margin		$ 1,850,000		$ 1,820,000	$ 30,000
Less: Traceable Fixed Costs		1,100,000		1,100,000	-
Location A Margin		$ 750,000		$ 720,000	$ 30,000

Drinks (36%) Burgers (40%) Fries (24%)

Notice that Location A's performance report is very detailed, and provides a basis for analysis of numerous facets of the business. Graphics are frequently used to facilitate understanding by those not accustomed to accounting reports. For example, each store supervisor knows that fries and drinks have the highest profit margins and they are encouraged to train employees to soft-sell these items by asking customers "what type of drink did you prefer?" rather than "did you want a drink with this order?" As a result, the report is "specialized" to show the product mix proportions. In addition, each manager gets a bonus if food costs are below 20% of sales; this incentive is designed to reduce food waste and encourage sales of high margin products. The report provides sufficient detail to show if the objectives are being met. Notice that unfavorable variances are highlighted in red. Summarizing the results for Location A, note that the budgeted goal for hamburger sales was not met. But, the profit objectives were nevertheless exceeded because the product mix of fries and drinks produced offsetting higher margins. In addition Location A managed to contain other variable costs.

The next step up in the organizational chart is the Senior Manager of Store Operations. This person is concerned with making sure that each Chapter is profitable. Underperforming stores are identified, problems are studied, and corrective measures are taken. Very little time is spent on locations that are meeting or exceeding corporate profit goals. Although this manager has access to the detailed reports for each store, the performance report of interest is a compilation of summary data for each location that quickly highlights the areas of needed improvement. Review the following performance report, noting the carry forward of Location A's data into the report. Obviously, some stores are performing much better than others; the senior manager will certainly want to focus on store E immediately! Also notice that there is $1,500,000 of fixed costs associated with store operations that are not traceable to any specific location; nevertheless, the senior manager of store operations must control this cost and it is subtracted in calculating the overall margin. Thus, the total fixed cost for all store operations is $9,500,000 ($8,000,000 + $1,500,000).

PERFORMANCE REPORT
ALL STORES
FOR THE YEAR ENDING DECEMBER 31, 20X5

	Combined	Location A	Location B	Location C	Location D	Location E	Location F	Location G
Sales:								
Burgers	$ 7,050,000	$ 1,000,000	$ 875,000	$ 1,200,000	$ 1,400,000	$ 600,000	$ 875,000	$ 1,100,000
Fries	3,675,000	600,000	400,000	750,000	800,000	200,000	300,000	625,000
Drinks	5,685,000	900,000	910,000	975,000	1,000,000	450,000	550,000	900,000
Total Sales	$ 16,410,000	$ 2,500,000	$ 2,185,000	$ 2,925,000	$ 3,200,000	$ 1,250,000	$ 1,725,000	$ 2,625,000
Less: Variable Expenses								
Food cost	$ 3,334,850	$ 475,000	$ 458,850	$ 526,500	$ 640,000	$ 337,500	$ 293,250	$ 603,750
Other variable expenses	1,241,100	175,000	131,100	234,000	224,000	112,500	207,000	157,500
Total Variable Expenses	$ 4,575,950	$ 650,000	$ 589,950	$ 760,500	$ 864,000	$ 450,000	$ 500,250	$ 761,250
Contribution Margin	$ 11,834,050	$ 1,850,000	$ 1,595,050	$ 2,164,500	$ 2,336,000	$ 800,000	$ 1,224,750	$ 1,863,750
Traceable Fixed Costs	8,000,000	1,100,000	1,000,000	900,000	1,200,000	1,300,000	1,100,000	1,400,000
Location Margin	$ 3,834,050	$ 750,000	$ 595,050	$ 1,264,500	$ 1,136,000	$ (500,000)	$ 124,750	$ 463,750
Common Fixed Costs	1,500,000							
Stores Margin	$ 2,334,050							

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Continuing up the organizational chart, the VP of Operations will focus on summary data from store management, catering management, and procurement. Notice that the "stores" column (below) is derived from information found in the "combined" column (above). Again, note the presence of fixed costs that are not traceable to any specific operating segment ($1,300,000). Even though this cost is not assigned to a specific segment, it remains a cost for which the VP of Operations is responsible.

PERFORMANCE REPORT
OPERATIONS
FOR THE YEAR ENDING DECEMBER 31, 20X5

	Combined	Stores	Catering	Procurement
Total Sales	$ 28,866,000	$ 16,410,000	$12,456,000	$ -
Total Variable Expenses	$ 6,942,590	$ 4,575,950	$ 2,366,640	$ -
Contribution Margin	$ 21,923,410	$ 11,834,050	$ 10,089,360	$ -
Less: Traceable Fixed Costs	17,700,000	9,500,000	7,000,000	$1,200,000
Unit Margin	$ 4,223,410	$ 2,334,050	$ 3,089,360	$ (1,200,000)
Less: Common Fixed Costs	1,300,000			
Operations Margin	$ 2,923,410			

The next step in the corporate ladder is the CEO. This individual is evaluated on the overall financial statement outcomes. Although the CEO would have access to any and all of the reports from within the organization, they would mostly focus on the reports emanating from each vice president's Chapter.

Questions

23. After analysing the case above, do you think all the organizations, especially those in catering/hoteliering business, should run on the same model of responsibility accounting? Support your argument with reasons.

24. What problems do you see in responsibility accounting at OTL Cuisines Inc.?

Source: www.otlcatering.com

Self Assessment

Fill in the blanks:

12. Assigning .... to lower level managers allows higher level managers to pursue other activities.

13. Segment managers and individual workers within segments tend to .... to optimize their .... performance measurements.

14. The accounting system of the company supports preparation of an .... for each responsibility center.

25. An implicit assumption of responsibility accounting is that separating a company into responsibility centers that are controlled in a .... manner is the way to optimize the system.

10.5 Transfer Pricing

Large business Chapters are usually organised into different divisions for better control. In such a situation, if one division supplies its finished output as input to other division, there arises a very important issue. The issue being at which price should be transferring Chapter transfer its product or service. Such price is known as transfer price.

Transfer prices are the amounts charged by one segment of an organization for a product or service that it supplies to another segment of the same organization.

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Transfer price in simple words is the price that one sub-Chapter (segment, department, division and so on) of an organization charges for a product or service supplied to another subChapter of the same organization. It is different from the normal price in that both divisions are a part of the same organisation and therefore it is only an internal transfer and not sale. The pricing of these flows is likely to have an impact on the performance evaluation of the divisions. Setting of transfer pricing policies within the company is of great significance. The important issue now is at what price should such transfers be made.

Did u know? ***Why do transfer-pricing systems exist?***

26. To communicate data that will lead to goal-congruent decisions.
27. To evaluate segment performance and thus motivate managers toward goal-congruent decisions.
28. Multinational companies use transfer pricing to minimize their worldwide taxes, duties, and tariffs. Ideally, the chosen transfer-pricing method should lead each subChapter manager to make optimal decisions for the organization as a whole. The three specific criteria that can help in choosing a transfer-pricing method are:

    Promotion of Goal Congruence: Goal congruence exists when each divisional or sub-Chapter manager acting in his or her own best interest takes actions that automatically result in achieving the organisation goals established by top management.

    Promotion of a Sustained High Level of Management Effort: Effort is defined as exertion towards a goal, for example, sellers are motivated to hold down costs of supplying product or service, and buyers are motivated to acquire and use inputs efficiently. The environment in the organisation should be such that a sustained high level of management effort is promised.

    Promotion of a High Level of SubChapter Autonomy in Decision-making: Autonomy is the degree of freedom a division manager can exercise in decisions making. If top management favours a high degree of decentralization, this criterion is of particular importance.

    Transfer pricing is a critical issue in the organisation. This is because the transfer price decides:

29. The revenue of the supplying division thus influences divisional profit; and
30. The cost of the receiving division thus influences divisional profit.

10.5.1 Objectives of Transfer Pricing

Some of the more important objectives of transfer pricing are as follows:

31. ***Evaluating Divisional Performance:*** Prices can be set in order to arrive at a valid measure of divisional profit for performance evaluation purposes. This should be of value to central management in allocating resources between divisions.
32. ***Improving the Quality of Decisions:*** Transfer pricing may help divisional managers to take better decisions. Prices can be used to determine how much of a product or service a particular division is prepared to sell and how much a division is prepared to buy. This can help in the efficient use of resources within a division.
33. ***Promoting Autonomy:*** Transfer pricing can help in promoting the autonomy of division. Divisional managers can make independent decisions concerning whether or not they wish

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to trade with other divisions based on the transfer prices which are quoted. This should help in supporting the policy of divisionalisation of the business.

34. ***Allocation of Profit:*** Transfer pricing can be used to allocate the profits of a multinational business to division operating in particular countries. The allocation process may be designed to minimise the liability of the business as a whole or to minimise taxation and duties. In addition, it is sometimes also used to avoid restrictions on the transfer of profit within a division that is situated in a country where taxes and duties are low and to report low levels of profit within a division where taxation and duties are high. This policy will enable the business, as a whole, to reduce its total liability to taxation (it should be noted that some taxation authorities will object to this practice if they believe this is simply a tax avoidance measure).

10.5.2 Transfer Pricing Methods

There are three general methods for determining transfer prices:

35. ***Market-based Transfer Prices:*** One of the most rational and practical basis of determining transfer price is the market price. A company may choose to use the price of a similar product or service publicity listed in, say a trade journal. Also, a company may select for its internal price the external price that a division charges to outside customers.

    Under certain circumstances deviation from market oriented transfer price may be justified. Some instances are:

    Where the products involved are highly specialised and a ready market does not exist, market-price determination will be more difficult.

    Where it is necessary to take advantage of economies of scale in the production of some goods or services.

    When it is necessary to shift resources from low priority to high priority divisions.

    Where considerations of taxation are applicable.

36. ***Cost-based Transfer Prices:*** The basis for transfer price can even be any price that is cost based. Examples of cost-based transfer prices include variable manufacturing costs, full manufacturing (absorption) costs, and full product costs. Full product costs include all production costs as well as costs from other business functions (R&D, design, marketing, distribution and customer service). This method of transfer pricing is normally used when a perfect market does not exist for the product. The division cost in this could be actual cost, standard cost, budgeted cost or marginal cost. The company has to decide which type of the above stated cost is to be taken into account for transfer pricing.

37. ***Negotiated Transfer Prices:*** In some cases, the divisions of a company are free to negotiate the transfer price between themselves. In the process of negotiation, divisions may use information about costs and market prices. However, there is no requirement that the chosen transfer price to have any specific relationship to either cost or market price data. Negotiated transfer prices are often employed when market prices are volatile. The negotiated transfer price is the outcome of a bargaining process between the selling and the buying divisions. This price normally is based on manufacturing costs plus an extra percentage added to approximate it to market price.

38. ***Variable-Cost Pricing***

    When market prices cannot be used, versions of "cost-plus-a-profit" are often used as a fair substitute.

Notes

- In situations where idle capacity exists, variable cost would generally be the better basis for transfer pricing and would lead to the optimum decision for the firm as a whole.

There is a large amount of documented sources on the transfer pricing policies used by companies all over the world. These studies have documented various aspects of transfer pricing policies such as:

- Its role as an overall component of reporting and control system in companies.
- The effect of transfer pricing on intra-corporate conflicts.
- Variations in transfer pricing policies across the world, and environmental constraints on use of transfer prices.

Self Assessment

Fill in the blanks:

40. ……………… are the amounts charged by one segment of an organization for a product or service that it supplies to another segment of the same organization.
41. The ……………… is the outcome of a bargaining process between the selling and the buying divisions.

10.6 Summary

- Responsibility accounting is a concept of accounting performance measurement systems.
- The basic idea under responsibility accounting is that large diversified organizations are difficult, if not impossible to manage as a single segment.
- Thus, they must be decentralized or separated into manageable parts.
- These parts or segments are referred to as responsibility centers that include: cost centers, profit centers and investment centers.
- This approach allows responsibility to be assigned to the segment managers that have the greatest amount of influence over the key elements to be managed.
- There are many advantages and disadvantages of responsibility accounting.
- The benefits exceed the limitations, thus rendering responsibility accounting a big space to settle in.
- Transfer prices are the amounts charged by one segment of an organization for a product or service that it supplies to another segment of the same organization.

10.7 Keywords

Cost Center: A cost center is part of an organization that does not produce direct profit and adds to the cost of running a company.

Investment Center: A Chapter within an organisation whose manager not only has profit responsibility but also some influence on capital expenditures.

Profit Center: A segment of a business for which costs, revenues, and profits are separately calculated.

Revenue Center: Chapter within an organization that is responsible for generating revenues.

Transfer Prices: Transfer prices are the amounts charged by one segment of an organization for a product or service that it supplies to another segment of the same organization.

Notes

10.8 Review Questions

50. Can responsibility be delegated? Why?
51. Analyse the concept of revenue centers. How are they evaluated in traditional responsibility accounting?
52. How would you evaluate cost centers in traditional responsibility accounting?
53. How does an investment center differ from a profit center?
54. How are investment centers evaluated in traditional responsibility accounting?
55. Examine the key elements of the responsibility accounting controversy.
56. Put arguments to support traditional responsibility accounting.
57. Present arguments against traditional responsibility accounting.
58. Examine the controllability concept related to responsibility accounting.
59. An issue closely related to responsibility accounting is the controversy over budgeting and how budgets are used. For example, Jensen describes a problem with typical executive compensation plans where bonuses are based on budget targets. He argues that corporate budgeting is a joke because it encourages managers to lie, cheat, lowball targets and inflate results. Explain Jensen's argument and proposed solution.
60. Identify the relative advantages and disadvantages of basing transfer prices on total costs, variable costs, and market prices.

Answers: Self Assessment

1. financial accounting
2. revenue center
3. cost center
4. Investment center
5. diversified
6. delegated
7. time, labour, cost
8. control
9. depreciation
10. secret reserve
11. motivate
12. responsibility
13. compete, own
14. accounting report
15. top down
16. Transfer prices
61. negotiated transfer price

10.9 Further Readings

Books David W. Young, *Techniques of Management Accounting,* McGraw Hill.

McNair, C. J. and L. P. Carr, *Responsibility Redefined: Changing Concepts of Accounting-based Control.*

Online links www.allbusiness.com

www.internalaccounting.com