

Chapter 5

Responsibility Accounting & Transfer Pricing

- Responsibility Accounting and Decentralization
- Objectives of transfer pricing system
- Methods of transfer pricing
- Conflict between a division and the company
- Multinational transfer pricing

Decentralization

- ❖ **Decentralization** is a transfer of authority, responsibility, and decision - making rights from the top to the bottom of the organizational structure. (OR)
- ❖ Firms that grant substantial decision making authority to the managers of subunits are referred to as decentralized organizations.

(OR)

- ❖ Decentralization is the freedom for manager at lower level of the organization to make decision.
- **Decentralization is generally appropriate for companies that**
 - Are mature
 - Are large
 - Are in a growth stage of product development
 - Are growing rapidly
 - Can financially withstand in correct decisions
 - Have high confidence in the employees' decision making ability
 - Have widespread operations
 - Want to challenge, motivate, and mentor employees
 - Require rapid response to changing conditions or opportunities

Advantages of Decentralization

Advantages:

- ❖ Helps top management recognizes and develop managerial talent.
- ❖ Allows managerial performance to be comparatively evaluated.
- ❖ Can often lead to greater job satisfaction and provides job enrichment.
- ❖ Makes the accomplishment of organizational goals and objectives easier.
- ❖ Reduces decision-making time.
- ❖ Increases motivation of subunit managers
- ❖ Allows the use of management by exception

Disadvantages of Decentralization

- Can result in a lack of goal similarity
- Requires more effective communication abilities because decision making is removed from the home office.
- Can create personnel difficulties upon introduction, especially if managers are unwilling or unable to delegate effectively.
- Can be extremely expensive, including costs of training and of making poor decisions.
- Focuses manager's attention on the subunit rather than the company as a whole.
- Results in duplication of output and activities

MEANING AND DEFINITION OF RESPONSIBILITY ACCOUNTING

- Responsibility accounting is a system of accounting that recognizes various responsibility centres throughout the organization and actions of each of these centres by assigning particular revenues and costs to the one having the pertinent responsibility. It is also called profitability accounting and activity accounting.

Charles, T.Horngreen

- Responsibility accounting is that type of management accounting that collects and reports both planned actual accounting information in terms of responsibility centres.”

Anthony and Reece

Responsibility Accounting Systems

- ❖ A **responsibility accounting system** facilitates decentralization by providing information about the **performance, efficiency, and effectiveness** of organizational subunits and their managers.
- ❖ Responsibility accounting is the key management control tool in a decentralized organization.
- ❖ A responsibility accounting system produces **responsibility reports** that assist each successively higher level of management in evaluating the performances of subordinate managers and their respective organizational units.
- ❖ The reports should be modified to fit the **planning, controlling, and decision-making needs of subordinate managers** and should include **both monetary and nonmonetary information**

Information for Responsibility Reports

Monetary Information

- ✓ Budgeted and actual revenues
- ✓ Budgeted and actual costs (computed on a comparable basis)
- ✓ Variance computations for revenues and costs
- ✓ Asset investment base

Non-monetary Information

- Capacity measures (theoretical and that used to compute predetermined overhead rates)
 - Target rate of earnings on investment base
 - Desired and actual market share
 - Departmental or divisional throughput
 - Number of defects (by product, product line, and supplier)
 - Number of orders backlogged (by date, cost, and selling price)
 - Number of customer complaints (by type and product); method of complaint resolution
 - Percentage of orders delivered on time
 - Manufacturing (or service) cycle efficiency

Nonmonetary Information

(Cont'd)

- Percentage of reduction of non-value-added time from previous reporting period (broken period, Down by idle time, storage time, move time, and quality control time)
- Number and percentage of employee suggestions considered significant and practical
- Number and percentage of employee suggestions implemented
- Number of unplanned production interruptions
- Number of schedule changes
- Number of engineering change orders; percentage change from previous period
- Number of safety violations; percentage change from previous period
- Number of days of employee absences; percentage change from previous

A responsibility accounting system helps organizational unit managers to conduct the **five basic control functions**:

- I. Prepare a plan** (e.g., using budgets and standards) and use it to communicate output expectations and delegate authority
- II. Gather actual data classified in accordance with the activities and categories specified in the plan.** The responsibility accounting system can be used to record and summarize data for each organizational unit

III. Monitor the differences between planned and actual data at scheduled intervals. Responsibility reports for subordinate managers and their immediate supervisors normally include **comparisons of actual results with flexible budget figures.**

❖ In contrast, responsibility reports can provide ***comparisons of actual performance to the master budget.***

IV. Exert /Apply managerial influence in response to significant differences.

- ❖ Because of day-to-day contact with operations, unit managers should be aware of any significant variances before they are reported, identify the variance causes, and attempt to correct them.
 - ❖ Top management, on the other hand, might not know about operational variances until it receives responsibility reports.
 - ❖ By the time top management receives the reports, the problems causing the variances should have been corrected, or subordinate managers should have explanations as to why the problems were not or could not be resolved.
- V. Continue comparing data and responding; then, at the appropriate time, the process will begin again**

Types of Responsibility Centers

- **Cost centers** are organizational units in which managers are primarily responsible for controlling costs (OR) The manager is accountable for costs only
- **Revenue centers** are organizational units in which managers are primarily responsible for **generating revenues (OR) Managers are accountable for revenues only**

Revenue Variances

- Revenue centers calculate variances created by price or volume of units sold.

- The sales price variance is calculated as actual volume $\times$ (Actual sales price - budgeted sales price).
- The sales volume variance is calculated as actual sales price $\times$ (actual volume - budgeted volume).
- The total revenue variance is calculated as sales price variance + sales volume variance.

- **Profit centers** are organizational units in which managers are responsible for **generating revenue, controlling costs, and maximizing their units' incomes (OR) The manager is accountable for revenues and costs**
- A **profit center** is an organizational unit whose manager is responsible for **generating revenues and managing expenses related to current activity.**
- Thus, profit centers should be independent organizational units whose managers:
 - Have the ability to obtain resources at the most economical prices.
 - Sell products at prices that will maximize revenue.
 - Have a goal of maximizing the center's profit.

- **Investment centers** are organizational units in which managers are responsible for **generating revenue, controlling costs, and producing a satisfactory return on the asset base** under their control.
- The manager is accountable for investment, revenues and costs.
- ❖ In addition, the center's manager has the authority to acquire, use, and dispose of plant assets to earn the highest feasible rate of return on the center's asset base.

Transfer Pricing

- ❖ **It is the price at which goods and services are charged and exchanged** between a company's divisions or segments.
- ❖ Transfer prices are Intra Company charges for goods or services bought and sold between segments of a decentralized company.
- ❖ They are an internal pricing mechanism that allows transactions between divisions or segments of a business to be measured and accounted for.
- ❖ Transfer prices affect the revenues and costs of the divisions involved.
- ❖ They do not affect the revenues and costs of the company as a whole.

Transfer pricing con'td

- ❑ It is not used for external pricing; it is used to set prices for transfers among a company's departments, divisions, or segments.
- ❑ Instead of allocating support department costs to user departments, support services can be “**sold**” to user departments using transfer prices.
- ❑ Top management must determine which method (allocation or transfer pricing) produces the most useful information.

Transfer pricing Cont'd

- Transfer prices are used in organizations to:
 - ❖ Enhance goal congruence(similarity)
 - ❖ Make performance evaluations among segments more comparable.
 - ❖ Change a cost center into a profit center.
 - ❖ Ensure optimal resource allocations.
 - ❖ Promote responsibility center autonomy.
 - ❖ Encourage motivation and communication among responsibility center managers.

Transfer pricing cont'd

There are three primary approaches to developing transfer prices:

- (1) The price may be based on the cost of the item up to the point at which it is transferred to the next department or process;
- (2) The price may be based on market value if the item has an existing external market; or
- (3) The price may be negotiated by the managers of the buying and selling divisions.

Transfer pricing con'td

- Transfer prices for goods or services can be calculated in a number of ways, but the following general rules are appropriate:
 1. The **maximum price** should be **no higher** than the **lowest market price** at which the buying segment can acquire the goods or services externally.
 2. The **minimum price** should be **no less** than the sum of the selling segment's incremental costs associated with the goods or services plus the **opportunity cost** of the facilities used.

Transfer pricing con'td

- ❑ Transfer prices may be **cost based**, **market based**, or **negotiated**; **a dual pricing system** can also be used to assign different transfer prices to the selling and buying units.

Transfer pricing con'td

Transfer prices are set between two boundaries:

- ❖ The **upper price boundary** is the lowest market price at which the product/service can be acquired externally.
- ❖ The **lowest price boundary** is the incremental cost of production or performance plus the opportunity cost of the facilities used.

1. MARKET BASED TRANSFER PRICES

- Equivalent to what is being charged in the outside market for similar goals .Therefore, it is **called the *external market price*.**
- ❖ If there is a comparative market for the product or services being transferred internally, using the market price as a transfer price will generally lead to the desired goal congruence & managerial effort.
- ❖ The market price may come from published price lists for similar products or services or it, may be the price charged by the products division to its external customers.
- ❖ The internal transfer price may be the external market price less the selling and delivery expenses that are not incurred on internal business.
- ❖ The major drawback to market based prices is that market prices are not always available for items transferred internally.

2. NEGOTIATED TRANSFER PRICES

- ❑ Companies heavily committed to segment autonomy often allow managers to negotiate transfer prices. The managers may consider both costs & market prices in their negotiations, but no policy requires them to do so.
- ❑ A negotiated transfer price is used, that is, a price is reached through bargaining between the managers of the selling and buying divisions.
- ❑ A negotiated transfer price is often used for internal pricing.

3. Cost-Plus Transfer Price

- ❑ Cost-Plus Transfer Price A cost-plus transfer price is based on either the full cost or the variable costs incurred by the producing division plus an agreed-on profit percentage.
- ❑ Similar to the gross margin pricing method
- ❑ Non Market Based Transfer Pricing

Negative transfer pricing system outcomes

- ❖ Disagreement between unit managers as to how the transfer price should be set.
- ❖ Additional organizational costs and employee time
- ❖ Underutilization or overutilization of services.
- ❖ The need for year-end entries to eliminate the transfer prices.

Positive transfer pricing system outcomes

- An appropriate basis for calculating and evaluating segment performance.
- Information to make rational acquisition decisions about transfers of goods and services between corporate divisions.
- The flexibility to respond to changes in demand or market conditions.

Transfer Prices in Multinational Companies

- ❑ Multinational companies using transfer prices encounter difficulties, including differences in
 - Tax systems,
 - Customs duties,
 - Freight and insurance costs,
 - Import/export regulations, and
 - Foreign-exchange controls.
- ❑ Multinational companies must attempt to determine what transfer price would be considered “reasonable” as if generated in an arm’s-length transaction.
- ❑ Multinational companies face an increase in transfer pricing audits by tax authorities.
- ❑ Advanced pricing agreements are binding contracts with tax authorities that indicate no adjustments or penalties will be assessed if the agreements are followed.

Tax

- Acts as project driver
- Ensures objectives are met
- Makes sure all tax requirements are met
- Handles notifications to tax authorities
- Provides documentation/defense

Con'td

Finance

- Advises and develops solutions for management systems
- Addresses the ability of the financial reporting system to handle implications of transfer pricing
- Provides required financial data, including segmented data and budgets
- Assists in (or takes primary responsibility for) developing and running transfer pricing models

Cont'd

Accounting

- Provides information on accounting systems, accounting rules, consolidation of accounts
- Administers invoicing/booking/settlement of intercompany payments

Legal

- Oversees development of intercompany legal agreements and legal pricing requirements

Information Technology

- Assists in developing software, a programming interface with the transfer pricing model, and an internal financial system

Customs

- Assesses valuation, duty impacts, and representation and notification requirements

SETTING TRANSFER PRICES

- ❑ The company uses transfer prices to transfer goods and services between divisions while
- ❑ Allowing them to retain their autonomy. The transfer price can motivate managers to act
- ❑ In the best interest of the company.
- ❑ To help explain the issues involved with transfer pricing, we will discuss four transfer pricing scenarios:

- 1. No outside suppliers are available.**
- 2. Outside suppliers are available, but the selling division is below capacity.**
- 3. Outside suppliers are available, and the selling division is at capacity.**
- 4. Outside suppliers are available, the selling division is below capacity, and alternative facility uses exist.**