

TRANSFER PRICING, NEGOTIATED TRANSFER PRICES, DIVISIONAL AUTONOMY

Greenwich plc

A mediator has been appointed by the head office of Greenwich plc to agree the purchasing of products X and X100. The original agreement was for the North Division to purchase X and the Essex Division to purchase X100 and the level of purchases to remain the same as the previous year.

The mediator appointed by head office has only recently joined the company and is recently qualified. He has worked for the management accountant at the North Division at another company but does not believe this helped him to get the job. Apparently this is the first time that a manager from head office has been asked to mediate in a dispute between divisions.

Initially the mediator talked to the two purchasing divisions separately. The managers at the North Division gave details of current market prices for product X and argued that Swansea was not lowering its prices in line with other suppliers. North Division also complained about the new profit targets that have been set by head office. Managers' were convinced that they must have the freedom to buy and sell outside the company.

The managers at the Essex Division told a similar story. They gave details of how market prices had fluctuated in the last 6 months. Their conclusion was that market prices would continue to fall and therefore the Swansea Division must reduce its prices. Again managers also argued that they must have the freedom to buy and sell outside the company.

Finally a meeting with the Swansea Division was held. The managers did not accept any of the points raised by the two purchasing divisions and argued that the current arrangement had worked well and did not need changing.

After returning to the head office the mediator wrote a short report summarising the details of the original agreement.

Details of the original agreement

The North Division purchases 3,000 units of product X from Swansea (the supplying division) and another 1,000 units from an external supplier. The market price for product X is £900 per unit. The Essex Division purchases 1,000 units of product X100 from Swansea and another 1,000 units from an external supplier.

Details of the revised agreement

Swansea will continue to produce products X and X100. All of its production will be sold to the North and Essex Divisions. No other customers are likely to found for these products in the short term given that supply is greater than demand in the market. The mediator carefully considered the issues raised by the managers and suggested the following compromise. He gave all of the divisions 7 days in which to comment.

Swansea will manufacture 2,000 units of X for the North Division and 500 units of product X100 for the Essex Division.

North will buy 2,000 units of X from Swansea and 2,000 units from an external supplier at £900 per unit.

Essex will buy 500 units of X100 from Swansea and 1,500 units from an external supplier at £1,900 per unit.

Swansea Division Data 1999:

Data based on original agreement

Product	X	X100
Direct materials	£200	£300
Direct labour	£200	£300
Variable overhead	£300	£600
Transfer price	£1,000	£2,000
Annual Volume	3,000 units	1,000 units

Requirements:

Question 1

Calculate the increase or decrease in profits for the three divisions and the company if the head office agreement is imposed on managers. Discuss the problems faced by mediator in this situation.

Question 2

Evaluate the implications of the following transfer pricing policies:

1. Transfer price = cost plus a mark-up for the selling division
2. Transfer price = standard cost plus a mark-up for the selling division.
3. Transfer price = incremental cost
4. Transfer price = price negotiated by the managers

Reference:

McGraw-Hill Higher Education

http://highered.mcgraw-hill.com/sites/0077098595/student_view0/case_studies.html