TRANSFER PRICING – It is the internal selling price used when goods and services are transferred between profit centres and investment centres in a decentralised organisation

Transfer pricing methods

1) Market-based prices – top management decides to use a transfer price similar to market price and this only works in a well-functioning market
   - Lead to optimal decision-making when three conditions are satisfied:
     a. The market for the intermediate product is perfectly competitive
     b. Interdependencies of subunits are minimal
     c. There are no additional costs or benefits to the company as a whole from buying or selling in the external market (instead of transacting internally)

2) Negotiated prices - prices represent the outcome of a bargaining process between the selling and buying subunits works better when the balance of power is evenly distributed between the two parties

$$\text{Minimum transfer price} = \underset{\text{up to the point of transfer}}{\text{Incremental cost per unit incurred}} + \underset{\text{to the selling subunit}}{\text{Opportunity cost per unit}}$$

3) Cost-plus prices – basically puts a mark-up on a relevant cost like variable production costs, variable and fixed production costs, full costs (including life-cycle costs). It is useful when market prices are not readily available or too costly to obtain

Transfer pricing under different scenarios

Scenario 1 – There is an external market and excess capacity in the supplying division

- This usually means that the internal department doing the supplying benefits from the trade as they wouldn't have made those profits otherwise. Hence the transfer price is a negotiated price under market price

Scenario 2 – there is an external market but no excess capacity

- If there is no excess capacity then the supplying division has to take into account the opportunity cost of lost profits on sale due to transfer

Scenario 3 – there is an external market but there is limited capacity in the supplying division

- If capacity is limited, then an opportunity cost (partial) needs to be accounted for in the transfer price

Scenario 4 – there is no external market and there is excess capacity in the supplying division

- As there is no opportunity cost with the transfer, the transfer is based on cost-plus mark-up

Scenario 5 – there is no external market and no excess capacity in the supplying division

- The transfer price will need to account for the opportunity cost on lost sales in other products due to the transfer

Transfer pricing has tax implications if transferring profits between countries with different tax regulations – profits shifting

- A service level agreement (SLA) is a contract between two units within an organisation which
  - establishes the nature of the service
  - outlines the responsibilities of each party
  - outlines terms of supply
  - determines the transfer price of the service