



WHEN YOU BUY FROM YOURSELF, HOW MUCH SHOULD IT COST?

The title may suggest a "play on words," but it is not. Were I to rely solely on professional jargon, a more appropriate title might have been "Intra-company Transfer Pricing." More precisely, within a multi-division company where one division transfers a product, resource, or service to another division and this transfer is accompanied by an accounting charge, the process is known as intra-company transfer pricing.

In an earlier era, the agribusiness industry was little concerned with this process and its concomitant problems. Businesses were small, their accounting systems were immature, profits and/or losses were singularly determined, and the basic functions performed by those firms were few in number and rarely distinguishable, one from another. Within the past two decades, however, substantial changes have occurred.

First, the agribusiness industry entered a period of rapid expansion through vertical integration. Food processors expanded forward into the food chain to add such functions as packaging, merchandising, and wholesaling. Others grew down the food chain to the point where products were being secured through contract farming or direct ownership of agricultural production units. Those firms supplying production resources elected to expand their operations to include the mining and manufacture of chemicals and minerals, the production and refining of petroleum products, and the contract purchase of hardware and equipment. Still other suppliers added a package of services

to their operations, offering credit, agronomic consultation, and computerized records management systems to their rural customers. Before long, what was once a single product, single function firm had grown into a large conglomerate containing a multiple of divisions, each responsible for the provision of a different product, service, or function.

Shortly thereafter, a second major change impacted the agribusiness industry. Simple cost accounting systems which had once proved adequate were now found totally lacking for the control of larger multi-divisional agribusiness firms. It became more obvious that if each division was to be managed properly, each would have to be individually assessed as a so-called "profit center." Revenues generated and costs incurred by each division were now to be critiqued. While modern accounting/computer technology facilitated this process of managerial review, it did require that each company division assign a cost or price to its entire array of resources, products, or services even though they were being utilized only by another division of the same company. As could have been anticipated, some real problems arose as the establishment of a price for a manufactured product dictated the cost of that product to those providing the marketing function. A high transfer price would complement the profitability of the manufacturing division, while diminishing the performance of the marketing division. Similar disputes rapidly arose amongst almost all divisional management personnel as each sought to improve their profit center results to the direct detriment of others.

Decentralization Of Management Controls

As agribusiness firms expanded, integrated vertically, and structurally separated into different divisions, the decentralization of managerial controls became a natural corollary. Assuming the company's main objective remained one of profit maximization, top management was soon plagued with interdivisional rivalries. Transfer pricing practices became the prime focus of the dilemma. It, therefore, became top management's responsibility to select and reestablish transfer pricing policies while preventing the interests of individual divisions from interfering with the achievement of overall company goals. In the process of selecting the "best" pricing policy which would reduce conflicts between supply/production/marketing/ distribution divisions, the following three basic transfer pricing alternatives emerged for their consideration: (1) cost-base transfer pricing, (2) market-oriented transfer pricing, (3) negotiated transfer pricing. Discussion follows on each of these pricing alternatives and a special attempt shall be made to detail the advantages and disadvantages of each.

Cost-Base Transfer Pricing

Cost-base transfer pricing, in fact, incorporates two sub-types of pricing methods. The first method is based on an analyses of total costs, i.e., actual variable costs incurred plus a fixed costs assessment generally assigned to the division by central management which reflects both the fixed costs directly associated with division operation plus a portion of central office overhead (generally apportioned through some weighting means). A second method includes base variable costs plus a mark-up (to reflect a profit factor) and all other fixed costs.

Quite obviously the major attribute of a cost-based transfer pricing system is that based on its procedure and/or formulae, haggling time between divisional management is reduced. Through the systems application, routine processing of

interdivisional transactions can be facilitated. It also assists the marketing division in pricing the final product insofar as cost data from the more primary divisions are now readily available. Finally, this system has the advantage of building a solid base of evidence in support of accounting practices should those practices or the total operation be subjected to a corporate tax audit.

The major limitations of the cost-based transfer pricing system are as follows. First, a base of comprehensive cost accounting may not exist. Second, this system fails to reference in any way the existence of competitive prices of raw materials or resources available to the company from outside the organization. In essence, this pricing system is isolated from marketplace consideration. Finally, if a marketing division is purchasing products from two or more manufacturing divisions, pricing differentials can easily "mask" inefficiencies in one or more of those divisions.

Market-Oriented Transfer Pricing

As the name of this pricing system suggests, the market and/or competitive prices for products at any divisional level establish the transfer price. It presumes that a marketing division could secure its products from the company's own manufacturing division or secure those same products from the outside market. Although the outside market is never (or rarely) accessed, the competitive price establishes the minimal intra-company transfer price between divisions.

One of the advantages of the market-oriented transfer pricing system is that it provides top management with a means for evaluating each division's performance from a market/competitive perspective. In addition, it forces divisional management personnel to remain acutely aware of the competition, thereby creating greater incentive for cost reductions within their divisions.

Perhaps its greatest disadvantage is the degree of difficulty administering an

inter-company transfer pricing system based on outside market prices . . . which are not always readily available and which are often volatile and unpredictable. Second, because divisions do not have to share their cost data under this system, a possible diffusion of product cost exists through the vertical transfer of product between divisions of a company. If, in fact, outside market prices are particularly attractive, a division may elect to go to outside sources for their product. This practice is rare, but when the option is particularly attractive, it creates a loss of sales to the company and forces the company to allocate overhead to its divisions suffering from the sales loss. Finally, where competition is absent or poorly defined, confusion abounds and attempts to resolve the issues within this pricing system only serve to worsen the dilemma.

Negotiated Transfer Pricing

Due to the problems encountered when using either the cost plus mark-up or market-oriented pricing systems, many agribusiness firms are looking for an alternative. For those firms, the negotiated transfer pricing system may be the answer. In addition to placing heavy responsibility on divisional management personnel to work together in solving their problems, this system provides top management with a means for evaluating the performance of each operating division based on profitability, efficiency, and competitive position. Again, as the name suggests, this system is based on the process of negotiations between the company's various divisions. The negotiated price, for example, will ideally be one which the manufacturing division is willing to accept and the marketing division is willing to pay. In reality, the negotiations process will include references to those items considered in the two pricing systems described earlier. For instance, the market price of products involved from outside suppliers must be acknowledged. Similarly, the cost plus mark-up price which the manufacturing division might obtain from direct sale to outside customers is to be considered.

Finally, some reference to an adequate return on investment for both divisions must enter into the discussion.

Negotiated Pricing Example

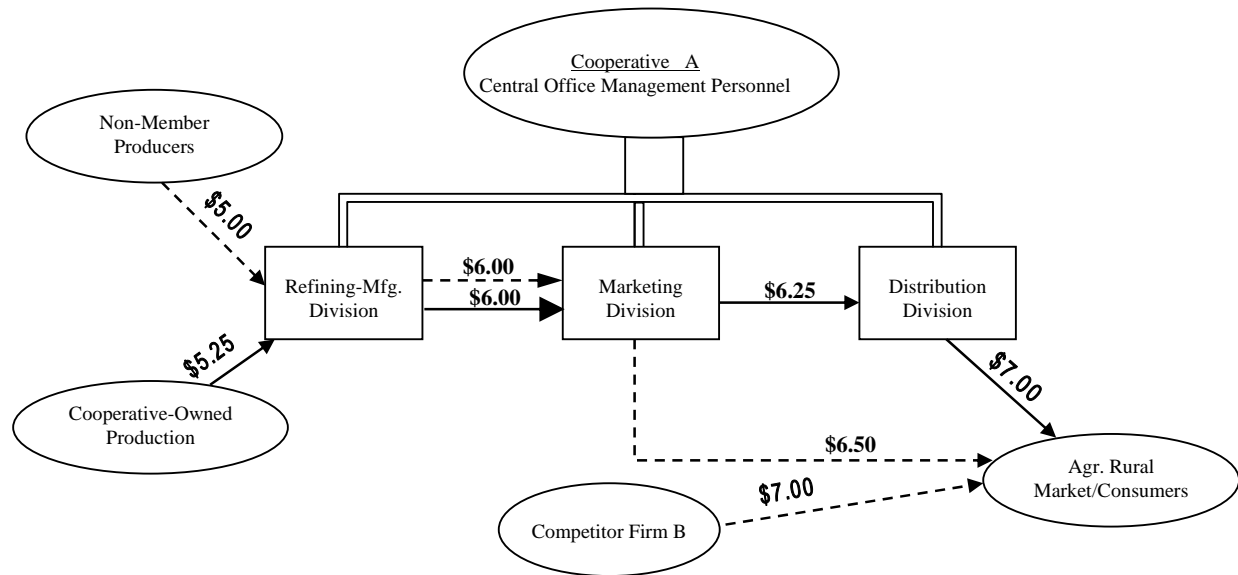
Figure 1 provides a classic example of an industry situation wherein intra-company pricing dilemmas arise. As shown, Cooperative A and Firm B compete with one another for the sale of petroleum products in the rural agricultural market. Cooperative A may elect to sell directly to larger rural consumers through its marketing division, or more commonly, through its distribution division with rural-based facilities. Its petroleum products are manufactured (refined) by its own division which receives crude oil supplies either from its own production facilities or on the open market from non-member producers. As the competition for the rural market has intensified in recent months, prices have diminished slightly and the dilemma of intra-company pricing has arisen. Products sold from rural based facilities by both Cooperative A and Competitor B have dropped to \$7.00.

Larger rural customers may secure this product directly from Cooperative A's marketing division for \$6.50, providing a substantial price advantage. At present, the marketing division is transferring product to the field-based distribution division (which has storage capacity) for \$6.25. The cooperative's manufacturing division transfers product to the marketing division for \$6.00 and has the option of securing crude oil supplies from open-market sources at \$5.00, or its company-owned production facilities for \$5.25.

It is now easy to see where several intra-company pricing conflicts emerge. The distribution division wants to lower its price to customers to \$6.75 and gain a \$.25 concession from the marketing divisions. Marketing personnel are reluctant to grant such transfer pricing concessions when direct sales to large customers provide a larger

Figure 1

Transfer Pricing Illustration



margin than that provided through field-based sales. Marketing may argue for transfer pricing concessions from the manufacturing division which is already suffering from a \$.25 disadvantage imposed by their company-owned supply source. Within the confines of these numerous conflicts there would seem to be no solution that would benefit all. Yet if Cooperative A is to under-price its competitor in this tenuous market, some accommodations are necessary. Clearly a negotiated settlement of intra-company transfer prices is required.

Negotiating the Pricing Dispute

Once the negotiated transfer pricing system is implemented and a dispute between operating divisions arises, the following procedural steps should be taken to reach a settlement more effectively:

- First, top management must appoint a pricing coordinator.

- Second, divisional management personnel and the newly appointed pricing coordinator must address the problem and assemble relevant data.
- Third, if outside sourcing of supplies or the direct sale by the marketing division is proposed, a review by the controller's office, based on data provided by the impacted division, should be conducted.
- Fourth, given the analyses by the controller's office, the coordinator seeks a mediated pricing settlement between those representing divisional interests.
- Fifth, until such time as a settlement is attained, existing patterns of sourcing and intra-company transfer pricing remains intact.

The process of negotiating a transfer pricing settlement very obviously requires the skills of a talented coordinator. Moreover, this coordinator must possess central office executive level credentials with commensurate power to mandate an arbitrated settlement. The coordinator's administrative responsibilities should encompass, but not be limited to: (1) establishing and communicating total corporate policies and objectives to the disputing divisional personnel; (2) evaluating all sources of information, weighing their relevant merits, and preparing recommendations for top management; and (3) assisting divisional management in settling intra-company pricing disputes without casting that process as a power struggle between different divisions of the same company.

Quite obviously, the selection of the pricing coordinator should be thorough and well-planned. If a pricing system is to be in place for a fiscal year, then the selection of the coordinator must be made at least six months earlier. This allows adequate time for a settlement to be reached and provides divisional management with an opportunity to plan for and budget under the new system. Subsequent monitoring of the performance of the new system, along with reviews of each division's R.O.I. performance, will give top management an adequate base from which to evaluate the new pricing system's results.

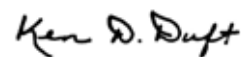
A successful settlement and pricing system implementation will provide top management with the following capabilities: (1) the continued need for, and ability to, measure each division under profit center parameters; (2) the vehicle for a settlement of interdivisional disputes over pricing where cost plus and market-oriented pricing systems have proven costly or inappropriate; (3) measuring divisional management performance commensurate with a decentralized profit center strategy; (4) providing a mechanism for alerting top management to the existence of competition and its impact on divisional performance; (5)

forcing divisional management to continue their search for production and/or operational efficiencies.

Summary

Agribusiness firms are no longer singular entities. They have grown larger, more diversified, and more vertically integrated. Many such firms have grown into multidivisional operations wherefrom disputes over intra-company transfer pricing systems arise. In certain organizations where the evaluation of divisional performance relied heavily on achieving a profit goal, the market-oriented and the cost plus mark-up pricing systems appeared to be used heavily and in concert with profit center analysis. But disputes amongst divisional management personnel soon arose as each division blamed the other for its own inefficiency. Where such disputes appeared almost insurmountable, the negotiated transfer pricing system proved more suitable, particularly where it placed a heavy responsibility on divisional management to work together in solving their problems.

Sincerely,



Ken D. Duft
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