MANAGEMENT ACCOUNTING – PERFORMANCE EVALUATION

Grahame Steven explains why it's tempting to manipulate transfer prices when moving products between a group's subsidiaries in different nations.

DuPont was the first company to recognise the need for transfer pricing when, in the early 20th century, some of its divisions started generating by-products from their manufacturing processes that other divisions could use as raw materials to make their products. It realised that transferring such materials for free would be unfair, since the supplying division would be subsidising the receiving division, which had previously bought them from a third party. The company initially used cost to price these transfers, but the DuPont management team that took over General Motors used market prices when it implemented transfer pricing at GM after World War I. So it seems that the debate about the most appropriate basis for transfer prices dates back to the origins of the idea.

A key objective of transfer pricing is the fair assessment of performance. The accounts will be distorted where there are significant levels of intra-company trading if transfer pricing isn't used or if an inappropriate method is adopted. This can lead to incorrect investment decisions and demotivate managers if they think that their division is subsidising another. But, when the internal trade occurs between subsidiaries in different countries, the company can gain a financial advantage by using transfer prices that won't assess performance fairly.

Consider a multinational with two subsidiaries in different EU countries that both use the euro. The subsidiary in country A makes products that it sells in its home market and to the subsidiary in country B. The selling price charged to the subsidiary in B, €50, is based on market price adjusted for internal savings on marketing, admin and so on. The market price for these goods in A is €60.

Table 1 calculates the profit made by the subsidiary in A from its external and internal sales and by the subsidiary in B that resells products bought from the subsidiary in A. The key difference between the two nations is the rate of corporation tax they charge: A's rate is 25 per cent while B levies 35 per cent. This difference could influence the company to change the transfer price charged to the subsidiary in B, since it would be better to make higher profits in country A, where the corporation tax rate is ten percentage points

1 Profits made by the two subsidiaries in countries A and B

Actual data	Subsidiary in A	Subsidiary in B	
Internal sales (units)	400,000		
External sales (units)	600,000	400,000	
Selling price per unit (€)	60	60	
Transfer price per unit (€)	50		
Production cost per unit (€)	30	50	
Operating expenses (€)	21,000,000	2,000,000	
Corporation tax rate	25%	35%	
P&L account	**Subsidiary in A**	**Subsidiary in B**	**Combined**
Sales (€)	56,000,000	24,000,000	80,000,000
Cost of sales (€)	(30,000,000)	(20,000,000)	(50,000,000)
Gross profit (€)	26,000,000	4,000,000	30,000,000
Operating expenses (€)	(21,000,000)	(2,000,000)	(23,000,000)
Profit before tax (€)	5,000,000	2,000,000	7,000,000
Corporation tax (€)	(1,250,000)	(700,000)	(1,950,000)
Profit after tax (€)	3,750,000	1,300,000	5,050,000

2 The impact of charging a higher transfer price

Revised data	Subsidiary in A	Subsidiary in B	
Internal sales (units)	400,000		
External sales (units)	600,000	400,000	
Selling price per unit (€)	60	60	
Transfer price per unit (€)	54		
Production cost per unit (€)	30	54	
Operating expenses (€)	21,000,000	2,000,000	
Corporation tax rate	25%	35%	
P&L account	**Subsidiary in A**	**Subsidiary in B**	**Combined**
Sales (€)	57,600,000	24,000,000	81,600,000
Cost of sales (€)	(30,000,000)	(21,600,000)	(51,600,000)
Gross profit (€)	27,600,000	2,400,000	30,000,000
Operating expenses (€)	(21,000,000)	(2,000,000)	(23,000,000)
Profit before tax (€)	6,600,000	400,000	7,000,000
Corporation tax (€)	(1,650,000)	(140,000)	(1,790,000)
Profit after tax (€)	4,950,000	260,000	5,210,000

lower. So the company would increase its after-tax profits by setting a higher price for the goods purchased by its subsidiary in B from its subsidiary in A. Table 2 shows the impact of charging €54 per unit. The cost of sales is increased by the same amount, so the combined gross profit is the same as in table A. Pre-tax profits are also unaffected, since operating expenses are unchanged. What changes is profit after tax, since the profits previously taxed at 35 per cent are now taxed at 25 per cent. The net effect is to increase after-tax profits by €160,000.

Tables 3 and 4 show how the company could increase its after-tax profits where the corporation tax situation is reversed – ie, where country A's rate is 35 per cent and B's is 25 per cent. This time its after-tax profits are increased by €160,000 when the selling price charged to the subsidiary is cut to €46.

Research has found that multinationals have indeed manipulated transfer prices in such ways, sacrificing the fair assessment of performance for financial gain. Our example shows the favourable impact of changing the unit transfer price by €4. But why stop there? Why not change it by €5, €6 or more? The answer: government intervention. Governments need to raise money to fund public spending, so they don't take kindly to losing tax revenue. Each country will try to ensure that transfer prices used by multinationals do not disadvantage it. This can put multinationals at risk of double taxation, since national tax authorities will probably seek to maximise their revenues by establishing transfer prices that are most appropriate for them.

The Organisation for Economic Development and Co-operation (OECD) introduced its model tax convention (MTC) in 1958. This framework, which is updated regularly, is the basis of many bilateral tax agreements between countries. The MTC provides guidelines for taxpayers that may be subject to taxation in more than one country. Transfer pricing is a key aspect of bilateral tax agreements, since a significant amount of international trade occurs between multinationals. The key principle for trading between related parties is that it should be done with "arm's-length prices" using one of the following approaches:

3 The impact of a transposition of corporation tax rates

Actual data	Subsidiary in A	Subsidiary in B	
Internal sales (units)	400,000		
External sales (units)	600,000	400,000	
Selling price per unit (€)	60	60	
Transfer price per unit (€)	50		
Production cost per unit (€)	30	50	
Operating expenses (€)	21,000,000	2,000,000	
Corporation tax rate	35%	25%	
P&L account	**Subsidiary in A**	**Subsidiary in B**	**Combined**
Sales (€)	56,000,000	24,000,000	80,000,000
Cost of sales (€)	(30,000,000)	(20,000,000)	(50,000,000)
Gross profit (€)	26,000,000	4,000,000	30,000,000
Operating expenses (€)	(21,000,000)	(2,000,000)	(23,000,000)
Profit before tax (€)	5,000,000	2,000,000	7,000,000
Corporation tax (€)	(1,750,000)	(500,000)	(2,250,000)
Profit after tax (€)	3,250,000	1,500,000	4,750,000

4 The impact of charging a lower transfer price

Revised data	Subsidiary in A	Subsidiary in B	
Internal sales (units)	400,000		
External sales (units)	600,000	400,000	
Selling price per unit (€)	60	60	
Transfer price per unit (€)	46		
Production cost per unit (€)	30	46	
Operating expenses (€)	21,000,000	2,000,000	
Corporation tax rate	35%	25%	
P&L account	**Subsidiary in A**	**Subsidiary in B**	**Combined**
Sales (€)	54,400,000	24,000,000	80,000,000
Cost of sales (€)	(30,000,000)	(18,400,000)	(50,000,000)
Gross profit (€)	24,400,000	5,600,000	30,000,000
Operating expenses (€)	(21,000,000)	(2,000,000)	(23,000,000)
Profit before tax (€)	3,400,000	3,600,000	7,000,000
Corporation tax (€)	(1,190,000)	(900,000)	(2,090,000)
Profit after tax (€)	2,210,000	2,700,000	4,910,000

- Comparable uncontrolled price. This method uses market prices for similar transactions between unrelated parties. This is the OECD's preferred option.
- Resale price. This method deducts a percentage from the sales price charged by the receiving division to establish a transfer price for the selling subsidiary. The deduction takes account of the selling division's costs and allows for a "profit".
- Cost-plus. This method is based on the selling division's costs.

It is generally easier to agree prices for goods bought and sold between subsidiaries since equivalent items are often traded between non-related firms. But it's often harder to agree an appropriate price for services, intellectual property, trade names and so on. The situation becomes more complex when trade in intangibles takes

place between subsidiaries in the developed world and those in developing nations.

Although transfer pricing guidelines are in place, companies can still fall foul of the law, sometimes inadvertently. Many have been found guilty of tax evasion. But they can avoid that risk by entering an advanced pricing agreement with the national tax authorities of the supplying and receiving subsidiaries.

Looking at our worked example again, what arguments could be put forward for changing current prices (assuming that the company is not seeking to evade tax)? The subsidiary in A could argue that the transfer price should be increased, since the market-adjusted price does not reflect the current level of support – R&D, marketing etc – or the future level of support that will be given to the subsidiary in B. It must be stressed that the multinational would be guilty of tax evasion if it were to misrepresent the level of support provided. It's also worth noting that, if the firm used different transfer prices for internal reporting purposes, it could find itself in a difficult position with the tax authorities if they were to discover this.

The repatriation of profits to foreign shareholders can often be difficult from countries with a currency that cannot be readily converted. Many countries, particularly those in the developing world, use these "soft" currencies. When there is a shortage of foreign exchange, priority is normally given to payments for imported goods and services. Dividends payable to foreign shareholders are consequently placed in a "pipeline" by the national bank and it can take years before they are remitted. Inflation erodes the value of the dividend and foreign shareholders are subject to exchange risk if the dividend is not translated into their home currency when it is placed in the pipeline.

The Andean common market pact of 1970 limited the level of dividends that could be repatriated to foreign shareholders to 14 per cent of issued share capital. In order to place higher dividends in the pipeline for future repatriation, foreign subsidiaries often issued bonus shares to increase their share capital. But many foreign shareholders weren't prepared to wait for an extended period to receive their profits. The payment of "higher" dividends also depended on the subsidiary's profitability and cash position. Many companies consequently charged higher prices for goods sold from a subsidiary in a hard-currency country to a subsidiary based in a soft-currency country to repatriate profits, since priority is normally given to payment for imports. While the tax effect is usually neutral if profits are repatriated by charging higher prices or paying dividends to a subsidiary tax resident in the same country as the parent, the situation changes when the subsidiary and parent are in separate countries with different tax regimes. It must be stressed that this is an illegal act if a country has enacted laws to prevent such practices or there is a bilateral tax agreement based on the OECD's MTC between the two nations concerned. Always check the relevant legislation carefully.

Multinationals may be tempted to manipulate transfer prices to gain a tax advantage or repatriate profits. But evasion is illegal and the penalties for breaking the law can be significant. Yield not unto temptation!

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(See also "Cost allocation", page 39.)

Exam practice

Try the following question to test your understanding. The answer will be published in the December issue of *Velocity*, CIMA's student e-magazine (www.cimaglobal.com/velocity).

A multinational company has a subsidiary that manufactures a key component for other subsidiaries around the world. Both the parent and the subsidiary that produces the component are resident for tax in France.

The company's subsidiary in Malaysia was recently approached by a local firm interested in selling it the component. The local manufacturer offered a price equivalent to $48 per unit. The Malaysian subsidiary then contacted head office for permission to source supply with the local firm, since the price it was quoting was $2 cheaper per unit than that charged by the French subsidiary.

The head office obtained the following information about the proposal:

- Number of components used by the Malaysian subsidiary: 50,000 a year.
- Price charged by French subsidiary: $50 per component.
- Variable costs incurred by French subsidiary: $40 per component.
- French corporation tax rate: 30 per cent.
- Malaysian corporation tax rate: 20 per cent.

The French subsidiary informed head office that, if the components were sourced in Malaysia, its surplus capacity would be used to make products for a non-group company. Sales to the non-group company were expected to be 40,000 units a year and the contribution per unit from these sales would be the same as what the subsidiary currently earns from its sales to Malaysia. The subsidiary's fixed costs would remain the same.

You are required to:

A Prepare a financial appraisal for the proposal by the Malaysian subsidiary to source its components from the local firm.

B Identify other issues that head office should consider in relation to this proposal.

P1 further reading

B Scarlett, *Management Accounting – Performance Evaluation CIMA Learning System* (2008 edition), CIMA Publishing, 2008.
The OECD's model tax convention: www.snipurl.com/40qls.
The OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*: www.snipurl.com/40qo9.