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Business, Company



# **Profit/Cost Calculation for Three Departments**

In the present scenario, Department A buys 3000 quantities of Part 101 internally from Department C and rest of the 1500 quantities from an outside raw material part supplier.

In the proposed scenario, it has been decided by the managers of Department A, B and C that Department A will buy 2000 units from Department C and rest of the 2000 units will be procured from the outside part supplier. This is because Department A thinks that procuring Part 101 from outside vendor costs less than procuring it from Department C. The total costs of procurement for Department A in the present case as well as the proposed case are shown in the table below.

The calculations in the above table clearly show that if Department A buys from outside, then the total cost of procurement, in the case of the proposed scenario, is less than the present scenario. The main reason for this is that the transfer price for Department C is \$1, 000 and the procurement cost from outside is \$900. In other words, Department A can save \$100 per unit by procuring from outside. From Department A's perspective, it is better to buy from the outside supplier than from Department C.

# The cost of buying the Part 101 from Department C is \$2, 000/ Unit

The cost of buying the Part 101 from outside vendor is \$1, 900/Unit It can be seen from the above calculation that making a purchase from the outside supplier decreases the cost per unit for department B. This is because Department C sells the Part 201 at a price \$100 more than the outside vendor. As Department B pays \$100 more per unit than it pays to the

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outside supplier, from the perspective of Department B, it is better to purchase from the outside supplier than from Department C. It may seem from the individual departmental perspectives that both department A and department B are better of buying parts form outside than buying from Department C.

Currently, Department C sells 1000 units of Part 201 at a transfer price of \$2, 000 and 3000 units of Part 101 at a transfer price of \$1, 000 to Department A.

According to the proposed scenario, Department C will sell 2000 units of Part 101 and 500 units of Part 201 to Department A and Department B respectively. The profits generated by selling the parts for Division C are as shown below:

It can be seen from the above table that a \$300 profit per unit is made by Department C by selling Part 101 to Department A and \$800 profit made per unit by selling part 201 to Department B. In the proposed plan, the total volume purchased from Department C is reduced. This will bring down the overall profit for the department. The proposed plan is, therefore, not profitable for Department C. From Department C's perspective the present condition is good but the proposed scenario will decrease the overall profit for the department as more and more parts will be procured from outside by Department A and Department B.

# Overall

The overall costs in the case of both the scenarios are as below: It is seen that the overall cost for division A and Division B will decrease in the case of the proposed scenario. However, as a whole, the company will make less profit from division C because division C will supply less products to Division A and B, and due to this reason, its profit will be reduced. In the proposed scenario, the overall cost for the company for both the products will shoot up. It is not a profitable proposition from the company's perspective.

#### **Transfer Price Policies**

Transfer Price – Cost and A Markup for the Selling Division In the majority of the cases, the division selling the products to another division or selling it outside determines the transfer price or selling price by adding a percentage over the total cost involved in manufacturing the product/part (Chwolka, Martini and Simons, 2010). For instance, in this case, Department C bears a cost of \$700 for Part 101. The department can add 30% to the cost and sell it to the other department. It is one of the transfer price policies mostly in use while determining the costs for manufacturing.

#### **Transfer Price - Fair market Value**

Sometimes, calculating the cost of manufacturing for an individual product is difficult. For instance, if a company uses a particular resource to make multiple products, determining the percentage of the resource cost to be attributed to one particular product becomes difficult (Chwolka, Martini and Simons, 2010). In such cases, departments use the price that is similar to the market price for the same kinds of product. For instance, in this case, Department C can take into account the supplier price of \$1, 900 for part 201 and then decide whether or not it will retain the price same as the fair market value or will keep it higher or lower than the fair market value. This type of transfer pricing is used especially for those products that are easily available in the market.

# **Transfer Price – Price Negotiated by the Managers**

Transfer price is a mechanism managers use to try increasing their profitability. A divisional head, thus, can project his division to be highly profitable by maintaining high transfer price when selling a product to other divisions (Chwolka, Martini and Simons, 2010). In the current case, though the cost of manufacturing the products for Division C is \$700 and \$1, 200 respectively, the transfer prices for the same to Division A and B are \$1, 000 and \$2, 000. Thus, Division C is projecting profitability to the top management of the company while Division A and Division B managers are going through a lot of suffering for being forced to buy at a price that is higher than the market price. In this case, therefore, it is important for different divisional mangers to communicate to each other and collectively take a decision as regards the transfer price so that all the divisions involved get equally benefitted.

# References

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