

# Market prices assignment



The three key properties of a management control system are described in this chapter but studied in three different chapters: (1) alignment with strategy-? Chapter 13, (2) fitness with organizational structure-? chapter 22, and (3) performance of managers and employees-? chapter 23. An organization in an economically feasible manner. Throughout the text the importance of providing relevant and reliable information to decision makers via the accounting information system has been emphasized.

Again that purpose is illustrated using transfer pricing in a decentralized organization as a way that accountants provide information to improve managers' decisions. This chapter progresses from a notation of a key property of the management control system-?" designed to fit the company's structure and the decision-making responsibility of individual managers"-? to a closer look at organizational structure-? centralized or decentralized-? to a detailed study of the role of transfer prices for a decentralized organization.

Included are multinational aspects and the impact of governmental levies, especially income taxes. CHAPTER OUTLINE Management control systems Overview of management control systems A. . Characteristics of an effective system Achieves its stated goal of guiding and improving decisions for benefit of company a. B. Is cost effective . Performs as designed d. Influences behavior of people who use it Role accounting information plays in system Specifics of management control systems B.

Learning Objective 1: Describe a management control system and its three key properties 1. Management control system: means of gathering and using

information to aid and coordinate the planning and control decisions throughout an organization and to guide the behavior of its managers and employees

Information gathering Both financial data and nonofficial data ii. Different kinds of information needed for different tasks Report: some companies use single report of balanced scorecard [Chapter 13] . Behavior of managers and employees .

Formal management control system Includes explicit rules, procedures, performance measures, and incentive plans Consists of several systems, including management accounting system and human resource system I'.

Informal management control system Includes shared values, loyalties, and mutual commitments among members of organization Includes company culture and unwritten norms about acceptable behavior 2. Key properties for evaluating an effective management control system a. Closely aligned to an organization's strategies and goals b.

Fit the organization's structure and the decision-making responsibility of individual managers c. Motivate managers and employees to give effort to achieve the organization's goals I. Motivation: desire to attain a selected goal (the goal-congruence aspect) combined with resulting pursuit of that goal (the effort aspect) Goal congruence: when individuals and groups work toward achieving the organization's goals-? managers working in their own best interest take actions that align with the overall goals of top management Effort: exertion toward achieving a goal it.

Incentives: a variety of rewards Do multiple choice 1. Assignment after L. O. 2. A. Management control system must fit organization structure B.

Decentralization raises additional set of management control issues 1. Total decentralization: minimum constraints and maximum freedom for managers at the lowest levels of an organization to make decisions a. Decentralization: freedom for managers at lower levels of the organization to make decisions-? empowers managers and employees of subunits to take decisive actions .

Autonomy: the degree of freedom to make decisions-? greater the freedom, greater autonomy 2.

Total centralization: maximum constraints and minimum freedom for managers at the lowest levels of an organization to make decisions Learning Objective 2: C. Benefits and costs of decentralization 1. Benefits of decentralization as advocated by supporters a. Creates greater responsiveness to local needs-? information is key to wise decisions Leads to gains from faster decision making c. Increased motivation of subunit managers Greater management development and learning Sharpened focus of subunit managers . Costs of decentralization as pointed out by advocates of more centralized decision making a.

Suboptimal decision making (loss of control) I. Suboptimal decision making: a decision's benefit to one subunit is more than offset by costs or loss of benefits to organization as a whole goals, subunit goals, and individual goals of decision makers May occur when no guidance given to subunit managers concerning the effects of their decisions on other parts of organization Most likely to occur when subunits are highly interdependent I'. Also called incongruent or dysfunctional decision making b. Decreased loyalty toward the organization I.

Managers may regard themselves as competitors and be unwilling to share information or to assist when needed I'. Managers may use information to further their own self-interest rather than organization's c. Increased costs of gathering information Duplication of activities Comparison of benefits and costs D. . Cost-benefit analysis of decentralization useful on function-by-function basis Benefits of decentralization generally greater when companies face uncertainties in their environments, require detailed local knowledge for performing various Jobs, ND have few interdependencies among divisions E.

Decentralization in multinational companies 1. Centralization more difficult with subunits in different countries and on different continents due to physical and practical aspects 2. Decentralization has drawback of lack of control F. Choices about responsibility centers 1. Responsibility centers used to measure performance of subunits in organizations [Chapter 6] a. Cost center-? manager accountable for costs only b. Revenue center-? manager accountable for revenues only d. Investment center-? manager accountable for investments, revenues, and costs 2.

Responsibility centers used in centralized or decentralized organizations Do multiple choice 2 and 3. Assign Exercises 22-16 and 22-17. III. Transfer pricing A. Overview of transfer pricing 1. Transfer prices used in decentralized organizations to coordinate actions and to evaluate performance of subunits Learning Objective 3: TEACHING TIP: An excellent case for use in helping students understand transfer pricing is Birch Paper Company. Quoting from the Solutions Manual (Problem 25-31) to accompany the 8th edition of this text-?" This classic case is undoubtedly the most widely used transfer pricing case in the world.

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It can be used for either a quick look or a thorough study of the subject ...

Birch Paper Company is an unusually “ rich” case because the instructor can use it as a springboard for exploring a variety of issues, including the philosophies of decentralized versus centralized management styles, the role of division managers in decisions concerning marketing, and the effects on organizational design of interdependencies among divisions. ” Though the date might put one off, the technique, that of active learning embodied in the method is most up to date, is found in the article, “ Classroom Experience in the Behavioral

Implications of Accounting Performance Evaluation and Measurement,” in the Accounting Review, April 1973. The article, written by R. Virgil, W. Nor, and S. Shone on pages 410-418, guides an instructor through the experiential use of the case. Because the case presents the basic concepts of transfer pricing (and other concepts), it is indeed timeless, as well as timely. A. Transfer price: price one subunit charges for a product or service supplied to another subunit of the same operation I. Creates revenues for the selling subunit and purchase costs for the buying subunit that affects each subunit’s operating income ‘.

Creates operating incomes used to evaluate subunit performance and motivate managers . A curious phenomenon . Activities within organization clearly marketer in nature I’. Prices for transfers among organization subunits has a distinctly market flavor iii. Rationale of optimizing subunit performance leads to optimizing performance of organization as a whole 2. Transfer prices help achieve an organization’s strategies and goals and fit its structure a. Promote goal congruence b. Promote sustained high level of

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management effort c. Helps to evaluate performance of individual subunits and their managers .

Promote high level of subunit autonomy in decision making if top management favors high level of decentralization Do multiple choice 4. Learning Objective 4: 3. Methods of transfer pricing that produce different operating incomes for individual subunits from different revenues and cost for individual subunits a. Market-based transfer prices b. Cost-based transfer prices c. Negotiated transfer prices [Exhibits 22-1 and 22- 2] B. Specifics of transfer pricing 1. Market-based transfer prices Learning Objective 5: with buying prices equal to selling prices and no individual buyers or sellers can effect those prices by their own actions I.

Use of market prices generally leads to optimal decisions if three conditions met ; Market for the intermediate product perfectly competitive ; Interdependencies of subunits minimal ; No additional costs or benefits to company as a whole in buying or selling in external market instead of transacting internally lie. Use of market prices motivates managers to deal internally and to take exactly the same actions as if dealing in the external market ill. Use of market prices serves to evaluate economic viability and profitability of each vision individually b.

Distress prices I. Use of term “ distress prices” to mean temporary drop below historical average market price when supply outstrips demand lie. Choice of transfer price when distress prices prevail ; Use of the distress price itself (for short run) if exceeds incremental costs of supplying product or service; otherwise buy from outside supplier Use of long-run average price

or “ normal” market price (for long run) unless price stays low for long period of time; consider closing subunit Do multiple choice 5 and 6. Assign Problems 22-27 and 22-28. 2. Cost-based transfer prices

Learning Objective 6: Avoid making suboptimal decisions when transfer prices are based on full cost plus a markup a. Use of full-cost bases (full cost plus a margin) i. Used when market prices unavailable, inappropriate, or too costly to obtain costs and then purchase from outside vendor expecting savings in variable costs that will not occur iii. Managers prefer full-cost-based transfer price (from surveys taken) Represent relevant costs for long-run decisions ; Facilitate external pricing based on variable and fixed costs ; Least costly to administer Ib. Other issues to consider

Activity-based cost drivers provide more refined allocation of costs to products Budgeted costs and budgeted rates provide advance notice of price to use 0 Overcomes problems of inefficiencies in actual costs 0 Eliminates affect of variations in quantity of units produced b. Variable cost bases i. Use can achieve goal congruence i'. May need to determine transfer payment differently for buying division than for selling division to evaluate division performance c. Prorating the difference between maximum and minimum transfer prices i. One possibility: budgeted variable cost plus transfer price t.

Requires sharing information about variable costs as each division has incentive to overstate variable costs for more favorable transfer price d. Dual pricing: using two separate transfer-pricing methods to price each interspersed transaction i. A single cost-based transfer price seldom exists that simultaneously meets evaluation criteria lie. Difference between two



prices creates corporate subsidy to one division iii. Not widely used in practice different tax Jurisdictions Top management concern that manager of supplying division does not have sufficient incentive to control costs

Insulate managers from frictions of marketplace 3. Negotiated transfer prices

Learning Objective 7: Understand the range over which two divisions negotiate the transfer price when a. Unused capacity available in supplying subunit b. Price between variable costs of supplying subunit and market price for buying subunit I. Set by bargaining strengths of two subunits, information about demand for services from external parties for supplying subunit, and information about external sources of supply for buying subunit it. Sensitive negotiations because each division's performance evaluated on basis of operating income ill.