**Module - Background**

**TRANSFER PRICING AND RESPONSIBILITY CENTERS**

**Modular Learning Objectives**

Keep the following objectives in mind as you work through the material in this module:

* Define the role of responsibility accounting.
* Differentiate between controllable and uncontrollable costs.
* Analyze structure of a decentralized organization.
* Define profit centers, cost centers, and investment centers.
* Compute transfer prices.
* Identify three main transfer pricing approaches.

**Required Reading**

This module covers the role of responsibility accounting and responsibility centers. Explore these topics further while keeping the above six objectives in mind. Click on the three arrows to explore each topic in more detail:

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The term responsibility accounting refers to an accounting system that collects, summarizes, and reports accounting data relating to the responsibilities of individual managers. A responsibility accounting system provides information to evaluate each manager on the revenue and expense items over which that manager has primary control (authority to influence).

A responsibility accounting report contains those items controllable by the responsible manager. When both controllable and uncontrollable items are included in the report, accountants should clearly separate the categories. The identification of controllable items is a fundamental task in responsibility accounting and reporting.

To implement responsibility accounting in a company, the business entity must be organized so that responsibility is assignable to individual managers. The various company managers and their lines of authority (and the resulting levels of responsibility) should be fully defined. Not all managers have equal authority and responsibility. The degree of a manager’s authority varies from company to company.

The controllability criterion is crucial to the content of performance reports for each manager. For example, at the department supervisor level, perhaps only direct materials and direct labor cost control are appropriate for measuring performance. A plant manager, however, has the authority to make decisions regarding many other costs not controllable at the supervisory level, such as the salaries of department supervisors. These other costs would be included in the performance evaluation of the store manager, not the supervisor.

Watch this short video to further explain the concept of responsibility accounting. <https://www.youtube.com/watch?time_continue=1&v=EsS0socI3I4>

Decentralization is the dispersion of decision-making authority among individuals at lower levels of the organization. In other words, the extent of decentralization refers to the degree of control that segment managers have over the revenues, expenses, and assets of their segments. When a segment manager has control over these elements, the investment center concept can be applied to the segment. Thus, the more decentralized the decision-making is in an organization the more applicable is the investment center concept to the segments of the company. The more centralized the decision making is, the more likely responsibility centers are to be established as expense centers.

Some advantages of decentralized decision making are:

* Managing segments trains managers for high-level positions in the company. The added authority and responsibility also represent job enlargement and often increase job satisfaction and motivation.
* Top management can be more removed from day-to-day decision-making at lower levels of the company and can manage by exception. When top management is not involved with routine problem solving, it can devote more time to long-range planning and to the company’s most significant problem areas.
* Decisions can be made at the point where problems arise. It is often difficult for top managers to make appropriate decisions on a timely basis when they are not intimately involved with the problem they are trying to solve.
* Since decentralization permits the use of the investment center concept, performance evaluation criteria such as ROI and residual income (to be explained later) can be used.

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There are three main types of responsibility centers—cost centers, profit centers, and investment centers. The fourth type, the revenue center will not be discussed here. In designing a responsibility accounting system, management must examine the characteristics of each segment and the extent of the responsible manager’s authority. Care must be taken to ensure that the basis for evaluating the performance of a cost center, profit center, or investment center matches the characteristics of the segment and the authority of the segment’s manager. The following sections discuss the characteristics of each of these centers and the appropriate bases for evaluating the performance of each type.

<https://www.youtube.com/watch?v=N84VVslVctU>

A cost center is a responsibility center incurring only expense items and producing no direct revenue from the sale of goods or services. Examples of expense centers are service centers (e.g. the maintenance department or accounting department) or intermediate production facilities that produce parts for assembly into a finished product. Managers of expense centers are held responsible only for specified expense items.

The appropriate goal of an expense center is the long-run minimization of expenses. Short-run minimization of expenses may not be appropriate. For example, a production supervisor could eliminate maintenance costs for a short time, but in the long run, total costs might be higher due to more frequent machine breakdowns.

A profit center is a responsibility center having both revenues and expenses. Because segmental earnings equal segmental revenues minus related expenses, the manager must be able to control both of these categories. The manager must have the authority to control selling price, sales volume, and all reported expense items. To properly evaluate performance, the manager must have authority over all of these measured items. Controllable profits of a segment result from deducting the expenses under a manager’s control from revenues under that manager’s control.

Closely related to the profit center concept is an investment center. An investment center is a responsibility center having revenues, expenses, and an appropriate investment base. When a firm evaluates an investment center, it looks at the rate of return it can earn on its investment base.

Typical investment centers are large, autonomous segments of large companies. The centers are often separated from one another by location, types of products, functions, and/or necessary management skills. Segments such as these often seem to be separate companies to an outside observer. But the investment center concept can be applied even in relatively small companies in which the segment managers have control over the revenues, expenses, and assets of their segments.

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Let us start with a brief video about transfer pricing. <https://www.youtube.com/watch?v=_Qwz_cMAnvg>

Profit centers and investment centers inside companies often exchange products with each other. The Pontiac, Buick, and other divisions of General Motors buy and sell automobile parts from each other, for example. No market exchange takes place, so the company sets transfer prices that represent revenue to the selling division and costs to the buying division.

A**transfer price** is an artificial price used when goods or services are transferred from one segment to another segment within the same company. Accountants record the transfer price as a revenue of the producing segment and as a cost, or expense, of the receiving segment. Usually no cash actually changes hands between the segments. Instead, the transfer price is an internal accounting transaction.

Segments are generally evaluated based on some measure of profitability. The transfer price is important because it affects the profitability of the buying and selling segments. The higher the transfer price, the better for the seller. The lower the transfer price, the better for the buyer.

Ideally, a transfer price provides incentives for segment managers to make decisions not only in their best interests but also in the interests of the entire company. For example, if the selling segment can sell everything it produces for USD 100 per unit, the buying segment should pay the market price of USD 100 per unit. A seller with excess capacity, however, should be willing to transfer a product to the buying segment for any price at or above the differential cost of producing and transferring the product to the buying segment (typically all variable costs).

In practice, companies mostly base transfer prices on (1) the market price of the product, (2) the cost of the product, or (3) some amount negotiated by the buying and selling segment managers.

**Check Your Understanding**

Check your understanding to make sure that you have a good grasp of the background material. If you are not comfortable with the concepts, review some of the material again or go to the optional resource for more examples.

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| **Final Thoughts**A responsibility center is a part or subunit of a company for which a manager has authority and responsibility. The company's detailed organization chart is a logical source for determining responsibility centers. The most common responsibility centers are the departments within a company.When the manager of a responsibility center can control only costs, the responsibility center is referred to as a cost center. If a manager can control both costs and revenues, the responsibility center is known as a profit center. If a manager has authority and responsibility for costs, revenues, and investments the responsibility center is referred to as an investment center.The existence of responsibility centers necessitates the setting of an internal price for the transfer of parts, goods, and services among units and responsibility centers. Transfer prices are contentious because management intervenes by creating policies which have an effect on the income of a responsibility center or unit.Transfers among international jurisdictions involve additional considerations. Not only accounting rules, but income taxation and duties affect pricing strategies. Most countries have regulations to help prevent the use of this pricing method as a means of evading taxes or similar unethical and illegal activities. |

**Reading**

For further detail refer to Dr. Walther’s accounting text and videos.

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| *https://tlc.trident.edu/content/enforced/102026-X_FUTURE_ACC201-MOD/images/principles%20of%20accounting%20icon.png?_&d2lSessionVal=oF3fhO6sBnJyZFDxxlLyimABj&ou=107901* | Walther, L. (2017). Chapter 23: [*Reporting to Support Managerial Decisions*](http://www.principlesofaccounting.com/chapter-23/).<http://www.principlesofaccounting.com/chapter-23/> |