NAME: FAYINMINU AKINBOLAJI

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INTERNATIONAL TRANSFER PRICING

Transfer pricing refers to the determination of the price at which transactions between related parties will be carried out. Transfers can be from a subsidiary to its parent (upstream), from the parent to a subsidiary (downstream), or from one subsidiary to another of the same parent. Transfers between related parties are also known as intercompany transactions.

There are two factors that heavily affect the manner in which in international transfer prices are determined. The first factor is the objective that headquarters management wishes to achieve through its transfer pricing practices. While the second factor affecting international transfer pricing is the law that exists in most countries governing the manner in which intercompany transactions crossing their borders may be priced.

DECENTRALIZATION AND GOAL CONGRUENCE

Business enterprises often are organized by division and top managers’ delegate or decentralize authority and responsibility to division managers. Some of the advantages of decentralization include:

1. Allowing local managers to respond quickly to a changing environment.
2. Dividing large, complex problems into manageable pieces.
3. Motivating local managers who otherwise will be frustrated if asked only to implement the decisions of others.

However, with advantages comes disadvantages and the biggest disadvantage is that managers who have been granted decision-making authority may make decisions that are in their self-interest but detrimental to the company as a whole. Goal congruence involves local managers being able to make decisions that are in line with corporate goals.

TRANSFER PRICING METHODS

The following three methods are commonly used:

1. Cost-based transfer price: The transfer price is based on the cost to produce a good or service.
2. Market-based transfer price: The transfer price charged a related party is either based on the price that would be charged to an unrelated customer or determined by reference to sales of similar products or services by other companies to unrelated parties.
3. Negotiated price: The transfer price is the result of negotiation between buyer and seller and may be unrelated to either cost or market value.

OBJECTIVES OF INTERNATIONAL TRANSFER PRICING

1. Performance Evaluation: To fairly evaluate the performance of both parties to an intercompany transaction, the transfer should be made at a price acceptable to both parties.
2. Cost Minimization: When intercompany transactions cross national borders, differences between countries might lead an MNC to attempt to achieve certain cost-minimization objectives through the use of discretionary transfer prices mandated by headquarters.

Other Cost-Minimization Objectives includes: avoidance of withholding taxes, minimization of import duties (tariffs), circumvent profit repatriation restrictions, etc.