Management Accounting Nature and Scope

Management Accounting is the presentation of accounting information in such a way as to assist management in the creation of policy and the day-to-day operation of an undertaking. Thus, it relates to the use of accounting data collected with the help of financial accounting and cost accounting for the purpose of policy formulation, planning, control and decision-making by the management.

Management accounting links management with accounting as any accounting information required for taking managerial decisions is the subject matter of management accounting.

Some leading definitions of Management Accounting are given below:

"Management Accounting is concerned with accounting information that is useful to management." —R.N. Anthony

"Management Accounting is the term used to describe accounting methods, systems and techniques which coupled with special knowledge and ability, assists management in its task of maximising profits or minimising losses. Management Accountancy is the blending together into a coherent whole, financial accounting, cost accountancy and all aspects of financial management." —Batty

"Management accounting is a system of collection and presentation of relevant economic information relating to an enterprise for planning, controlling and decision-making." **—ICWA of India**

"Management accounting is the provision of information required by management for such purposes as formulation of policies, planning and controlling the activities of the enterprise, decision-making on the alternative courses of action, disclosure to those external to the entity (shareholders and others), disclosure to employees and safeguarding of assets." **—CIMA London**

Management Accounting is "the application of appropriate techniques and concepts in processing historical and projected economic data of an entity to assist management in establishing plans for reasonable economic objectives and in the making of rational decisions with a view towards these objectives". **—American Accounting Association**

From the above it is clear that management accounting uses all techniques of financial accounting, cost accounting and statistics to collect and process data for making it available to management so that it can take decisions in a scientific manner.

Nature of Management Accounting:

(i) Technique of Selective Nature:

Management Accounting is a technique of selective nature. It takes into consideration only that data from the income statement and position state merit which is relevant and useful to the management. Only that information is communicated to the management which is helpful for taking decisions on various aspects of the business.

(ii) Provides Data and not the Decisions:

The management accountant is not taking any decision by provides data which is helpful to the management in decision-making. It can inform but cannot prescribe. It is just like a map which guides the traveller where he will be if he travels in one direction or another. Much depends on the efficiency and wisdom of the management for utilizing the information provided by the management accountant.

(iii) Concerned with Future:

Management accounting unlike the financial accounting deals with the forecast with the future. It helps in planning the future because decisions are always taken for the future course of action.

(iv) Analysis of Different Variables:

Management accounting helps in analysing the reasons as to why the profit or loss is more or less as compared to the past period. Moreover, it tries to analyse the effect of different variables on the profits and profitability of the concern.

(v) No Set Formats for Information:

Management accounting will not provide information in a prescribed proforma like that of financial accounting. It provides the information to the management in the form which may be more useful to the management in taking various decisions on the various aspects of the business.

Scope of Management Accounting:

The scope of management accounting is very wide and broad-based. It includes all information which is provided to the management for financial analysis and interpretation of the business operations.

(i) Financial Accounting:

Financial accounting though provides historical information but is very useful for future planning and financial forecasting. Designing of a proper financial accounting system is a must for obtaining full control and co-ordination of operations of the business.

(ii) Cost Accounting:

It provides various techniques of costing like marginal costing, standard costing, differential and opportunity cost analysis, etc., which play a useful role n t operation and control of the business undertakings.

(iii) Budgeting and Forecasting:

Forecasting on the various aspects of the business is necessary for budgeting. Budgetary control controls the activities of the business through the operations of budget by comparing the actual with the budgeted figures, finding out the deviations, analysing the deviations in order to pinpoint the responsibility and take remedial action so that adverse things may not happen in future.

Both the techniques are necessary for management accountant.

(iv) Cost Control Procedures:

These procedures are integral part of the management accounting process and includes inventory control, cost control, labour control, budgetary control and variance analysis, etc.

(v) Reporting:

The management accountant is required to submit reports to the management on the various aspects of the undertaking. While reporting, he may use statistical tools for presentation of information as graphs, charts, pictorial presentation, index numbers and other devices in order to make the information more impressive and intelligent.

(vi) Methods and Procedures:

It includes in its study all those methods and procedures which help the concern to use its resources in the most efficient and economical manner. It undertakes special cost studies and estimations and reports on cost volume profit relationship under changing circumstances.

(vii) Tax Accounting:

It is an integral part of management accounting and includes preparation of income statement, determination of taxable income and filing up the return of income etc.

(viii) Internal Financial Control:

Management accounting includes the internal control methods like internal audit, efficient office management, etc.

(ix) Interpretation:

Management accounting is closely related to the interpretation of financial data to the management and advising them on decision-making.

(x) Office Services:

The management accountant may be required to maintain and control office services in some organizations. This function includes data processing, reporting on best use of mechanical and electronic devices, communication, etc.

(xi) Evaluating the Performance of the Management:

Management accounting provides methods and techniques for evaluating the performance of the management. It evaluates the performance of the management in the light of the objectives of the organisation. Thus, it helps in the implementation of the principle of management by exception.

Objectives of Management Accounting:

The fundamental objectives of management accounting are to enable the management to maximize profits or minimize losses. The evolution of managerial accounting has given a new approach to the function of accounting.

The main objectives of management accounting are as follows:

(1) Planning and policy formulation:

Planning involves forecasting based on available information, setting goals; framing policies determining the alternative courses of action, and deciding on the program of activities. Management Accounts can help greatly in this direction. It facilitates the preparation of statements in light of past results and gives an estimation for the future.

(2) Interpretation process:

Management Accounts to present financial information to the management. Financial information is technical. Therefore, it must present in such a way that it is easily understood. It presents accounting information with the help of statistical devices like charts, diagrams, graphs, etc.

(3) Assists in the Decision-making process:

With the help of various modern techniques management accounting makes the decision-making process more scientific. Data relating to cost, price, profit, and savings for each of the available alternatives are collected and analyzed and provides a base for making sound decisions.

(4) Controlling:

It is useful for managerial control. Their tools like standard costing and budgetary control help control performance. Cost control is effected through the use of standard costing and departmental control is made possible through the use of budgets. The performance of every individual is controlled with the help of managerial accounting.

(5) Reporting:

Management Accounts keeps the management fully informed about the latest position of concern through reporting. It helps management to take proper and quick decisions. The performance of various departments is regularly reported to the top management.

(6) Facilitates Organizing:

“Return on Capital Employed” is one of the tools of Management Accounts. Since managerial accounting stresses more on Responsibility Centre’s to control costs and responsibilities, it also facilitates decentralization to a greater extent. Thus, it helps set up an effective and efficient organization framework.

(7) Facilitates Coordination of Operations:

Management accounts provide tools for overall control and coordination of business operations. Budgets are an important means of coordination.

Financial Accounting: Nature, Scope, and Objective

Financial accounting is a branch of accounting which records each financial information and analyse it to determine the financial position of a business. It is a process of recording, summarising, analysing and presentation of all financial transactions of a business in the form of financial statements. Financial accounting involves the preparation of various financial statements like income statement, cash flow statement, balance sheet etc. using accounting principles.

These financial statements are prepared on a routine basis by companies and presented to all its stakeholders. Financial accounting aims at delivering the fair and accurate image of financial affairs of business to all its stakeholders. It is done in accordance with rules provided by GAAP or IFRS. It is an important tool for management in their decision making as they depend on financial reports for decision making and forecasting purposes.

Scope of Financial Accounting

Records Financial Transactions

Financial accounting record each and every financial transaction taking place in the business organisation. It maintains a clear and systematic record of all information in the form of journals and various subsidiary books. It avoids any confusion or loss because if any problem arises these records can be easily checked. All transaction cannot be just memorized by humans without recording them and that makes the financial accounting important part of every business.

Classify And Summarize Information

Information collected and recorded by financial accounting is properly categorized according to their nature. Financial accounting involves classifying and summarizing all financial information recorded at the initial step. All transactions of similar nature are grouped together under one head by making accounts like Sales, Purchase, Rent, Salaries, Interest etc. Grouping of same nature transactions together adds convenience in understanding of information collected.

Prepares Financial Statements

Financial accounting prepares financial statements like cash flow statement, income statement, balance sheet etc. These financial statements depict the true financial position of business. Financial statements are the result of various information collected and analysed in overall process of financial accounting. All financial strength and weakness of business are determined by preparation of financial statements.

Interprets Financial Information

Financial accounting interprets information from several analysis conducted and financial statements prepared. It understands and explains the results of several relationships establishes by analysis to different users for easy understanding and decision making. It simplifies the accounting information so that it is well understood by persons having limited or no knowledge of accounting subject.

Communicates All Outcomes

Financial accounting serves the needs of all external stakeholders by delivering them true and accurate picture of the company’s financial affairs. It communicates them all financial information by providing them with financial reports routinely. All interested parties to business are fully aware of all business financial matters and this helps them in making conclusions. It helps them in knowing profitability and future growth aspects through these reports.

Determines And Maintains Financial Position

Financial accounting determines fair and actual image of financial position of business. Finance is termed as lifeline of business activities and its management is quite important for every organisation. Mismanagement of financial resources may have adverse effects on the company's performance. Financial accounting records and analyse each financial aspect of business.

It delivers all information to internal management team from time to time for their decision making. Management are able to take all necessary steps whenever required related to financial resources which will improve the overall productivity. This all helps in maintaining a proper financial position for every business.

Nature of Financial Accounting

Accounting Is First Step

Accounting is start when a financial transection take place. It records the financial transection after that communicates this information to its users. then the user this information for their decision making.

Accounting Is An Art And Science:

Accounting is an Art and Science as well. Accounting is an art of recording, classifying and summarizing of financial transactions. Accounting is science as well as it requires certain principles (accounting principle).

Accounting Is A Process

Accounting is a process recording of financial transaction, summarizing, analyzing, and reporting to the user of accounting information.

Accounting Deals With Financial Transactions Only

financial accounting is considering only monetary transactions. It does not take into account various non-financial aspects such as market competition, economic conditions, government rules, and regulations, etc.

Historic In Nature

Financial accounting considers only those transactions which are of historic nature. day-to-day activities transactions are recorded and the information is provided after a period of time. All financial decisions of the future are taken on the basis of this past information

Records Actual Cost

Financial accounting records the actual cost of the transaction and does not consider the price fluctuations taking place from time to time. It records the historical cost or the actual cost of the assets or liability.

Objectives of Financial Accounting

(1) Maintaining Systematic Records Of Transactions

The objective of Financial accounting is to Systematic record the financial transactions of an organization in the books of account. Records are in chronological order or date and time wise. It can use in the future when we require it for further process.

(2) Ascertaining Profit Or Loss

To ascertain whether the organization have earned profit or incurred loss an Income statement or Trading and profit & loss account is prepared. The income statement gives the data of profit and loss of a financial year. The balance sheet gives the overall position of the organization.

(3) Ascertaining Financial Position

Another objective of Accounting is to ascertain the financial position by preparing the Balance sheet. The balance sheet contains assets and liability that give information about the financial position of the organization.

(4) Assisting The Management

Financial accounting Provides financial information to management for decision making. The information includes the debtors and creditor, profit & loss and other information.

(5) Provide Accounting Information To Users

Financial Accounting provides the required information to interested users Who analyze them as per their requirement. Users can be internal or external. Internal users are the management, employees, and external user are creditors, tax authorities, investors, etc.

What is Responsibility Accounting?

Responsibility accounting is a kind of management accounting that is accountable for all the management, budgeting, and internal accounting of a company. The primary objective of this accounting is to support all the Planning, costing, and responsibility centres of a company.

The accounting generally includes the preparation of a monthly and annual budget for an individual responsibility centre. It also accounts for the cost and revenue of a company, where reports are accumulated monthly or annually and reported to the concerned manager for the feedback. Responsibility accounting mainly focuses on responsibilities centres.

For instance, if Mr X, the manager of a unit, plans the budget of his department, he is responsible for keeping the budget under control. Mr X will have all the required information about the cost of his department. In case, if the expenditure is more than the allocated budget than Mr X will try to find the error and take necessary action and measures to correct it. Mr X will be personally accountable for the performance of his unit.

Explanation

- Basically, responsibility accounting is defined and based on the defined centers like cost centers, profit centers, and investment centers.
- Responsibility accounting is a sort of management accounting that is responsible for internal accounting, budget related issues, and management concerns.
- The main and crucial objective is to support all the centers within the company and help them with costing and planning.

- The accounting we referred to above relates to the preparation of annual or monthly budget which is allocated or designed for any particular center.
- This accounting style also accounts for the revenue and cost of any company, where quarterly and annual reports are being accumulated and then reported to the manager for the review or feedback.
- In responsibility accounts, a specific person is a help responsible for looking into an assigned area of accounting and cost control of the same, so that it is convenient to hold the person responsible for any increase in cost.
- In this accounting, tasks and responsibilities are assigned based on the knowledge and skillset an individual possess, and proper authority might be given to that person so that he can autonomously take decision pertaining to that department.

History of Responsibility Accounting

- The responsibility accounting was introduced in the year 1920s with the intention to handle all the different levels of authority in any organization's management.
- During the 1950s and 1960s, the economic activities of the companies were significantly diversified significantly increasing the demand of responsibility accounting and decentralization.

Definitions

According to Charles T. Horngren, "Responsibility accounting is a system of accounting that recognises various decision centres throughout an organisation and traces costs to the individual managers who are primarily responsible for making decisions about the costs in question".

Eric L. Kohler defines responsibility accounting as “a method of accounting in which costs are identified with persons assigned to their control rather than with products or functions”.

Significance of responsibility centers

1. Assigning of Responsibility:

Each and every individual in the organisation is assigned some responsibility and they are accountable for their work. Everybody knows what is expected of him. The responsibility can easily be identified and satisfactory and unsatisfactory performances of various persons are known. Nobody can shift responsibility to anybody else if something goes wrong. So, under this system responsibility is assigned individually.

2. Improves Performance:

The assigning of tasks to specific persons acts as a motivational factor too. The person’s in-charge for different activities know that their performance will be reported to the top management. They will try to improve their performance. On the other hand, it acts as a deterrent for low performance also because persons know that they are accountable for their work and they will have to explain for their low performance.

3. Helpful in Cost Planning:

Under the system of responsibility accounting, full information is collected about costs and revenues. This data is helpful in planning of future costs and revenues, fixing of standards and preparing of budgets.

4. Delegation and Control:

This system enables management to delegate authority while retaining overall control. The authority is delegated according to the requirements of the task assigned. On the other hand, responsibility of various persons is fixed which is helpful in controlling their work. The control remains with top management because performance of every cost centre is regularly reported to it. So management is able to delegate authority and at the same time to retain control.

5. Helpful in Decision-Making:

Responsibility accounting is not only a control device but also helpful in decision-making. The information collected under this system is helpful to management in planning its future actions. The past performance of various cost centres also helps in fixing their future targets. So this system enables management to take important decisions.

5 Main Types of Responsibility Centre

1. Cost Centre:

These are segments in which managers are responsible for costs incurred but have no revenue responsibilities. The performance of each cost centre is evaluated by comparing the actual amount with the budgeted/standard amount. Such centres may be made according to location or person or service or type of product.

It is essential to differentiate between controllable costs and uncontrollable costs while judging the performance of such centres. A manager responsible for a particular cost centre will be held responsible for only controllable costs.

Cost centres relate to costs only and they do not relate to revenues or assets and liabilities of the organisation. A cost centre may be a personal cost centre or impersonal cost centre such as cost centre according to location.

From functional point of view, a cost centre may be any of the following:

(a) Production Cost Centre:

It is a cost centre where production of goods is done such as in steel rolling mill hot mill, cold mill, hardening, polishing and grinding departments can be cost centres. The number of production cost centres in a factory depends upon the nature of industry, type of work performed and the size of the factory.

(b) Service Cost Centre:

It is a cost centre which renders services to production cost centres. It is not directly engaged in production though its existence is very essential for smooth and efficient running of production departments. Such cost centres as electricity or repairs and maintenance or boiler plant render a particular type of service for the benefit of other departments.

(c) Ancillary Manufacturing or Partly Producing Cost Centre:

Such type of cost centre may normally be a service department but sometimes does some productive work. A packing department producing packing materials will come under this category.

2. Revenue Centre:

It is a centre mainly devoted to raising revenue with no responsibility for production. The main responsibility of managers of such centres is to generate sale revenue. Such managers have nothing to do with the cost of manufacturing a product or in the area of investment of assets. But he is concerned with control of marketing expenses of the product.

3. Profit Centre:

This is a centre which has the responsibility of generating and maximising profits is called profit centre. This is a centre whose performance is measured in terms of both expenses it incurs and revenue it earns. Thus a factory may constitute a separate profit centre and sell its production to other department or the sales department.

Even within the factory, the services departments (as maintenance department) may sell their services to the production department. This is the practice in large undertakings where each divisional manager is given a profit objective and his performance is measured accordingly. The main problem in designing control system on the basis of profit centre arises in fixing transfer pricing.

Benefits of Creating Profit Centres:

(i) Better planning and decision making—Profit centres managers are independent in managing the activities and are responsible for profit and success of their business units. This encourages them to make better planning, profitable decisions and exercise control. It creates a sense of accountability among the profit centre managers.

(ii) Participation in organizational plans and policies— Although profit centre managers are independent in the management of their business units, they function within the umbrella of overall organization. They get opportunities to participate in the discussion of plans and policies at the firm level. This widens their perspective and inculcates the habit of taking an integrated and macro view of activities in place of a narrow division specific view. In this process, profit centres managers can get trained to be the senior managers of their companies or other firms in the future.

(iii) Beneficial competitive environment—All profit centres managers target success and profit by managing costs and aiming higher revenues. This creates a competitive environment among the managers managing their respective business units which is not only beneficial for them but also contributes in achieving the overall objectives of the firm and in maximizing the firm profit.

Essentials of a Profit Centre:

The basic requirements of a profit centre are as follows:

(i) Operational autonomy:

Business unit managers should have sufficient freedom to take operating decisions on a profit-oriented basis, for example, regarding purchase, product mix, pricing and inventory. Unless they have sufficient autonomy to take decisions in respect of the above, the very purpose of delegating authority and treating profit as a measure of divisional performance would be defeated.

(ii) Sourcing inputs and markets for products:

Business unit managers must have authority to source supply and markets to make profitable and sound make-or-buy decisions. Even if they are not permitted to actually purchase from external suppliers or from parties outside the organisation, they should be able to gain full information regarding demand and supply conditions and the prevailing and expected price trend in the industry.

(iii) Measurable costs and revenues of different profit centres:

The inputs and the outputs of the profit centres should be capable of separate measurement. By this, the need for apportionment of common input and output is minimized if not altogether eliminated. This makes it essential that the boundaries of different profit centres/divisions be clearly demarcated to preclude overlapping of activities. In the absence of well-defined boundaries and consequent overlapping of operations, unit managers may tend to take credit for everything that goes well and blame the other division for whatever goes wrong.

(iv) Using profit as a measure of performance:

Although the contribution of a profit centre can not be measured solely by the amount of profit contributed by it, profit must be treated as the main measure of a business unit's performance by the top management. If the top management does not give weightage to this, the divisional manager will tend to show less concern for this vital aspect of performance.

(v) Size of profit centre:

Unless the division is large enough, it should not be treated as a profit centre. A small workshop or a section of a department, for instance, can not be regarded as a profit centre. There should be a sizeable amount of work being performed in the business unit for it to be under the charge of a senior executive such as a general manager or divisional manager who could be given decision-making powers and the responsibility for all its activities, including profit performance.

4. Contribution Centre:

It is centre whose performance is mainly measured by the contribution it earns. Contribution is the difference between sales and variable costs. It is a centre

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devoted to increasing contribution. The main responsibility of the manager of such a responsibility centre is to increase contribution. Higher the contribution better will be the performance of the manager of a contribution centre.

A manager has no control on fixed expenses because these expenses are constant and depend on policy decisions of the higher level of management. He can control contribution by increasing sales and by reducing variable costs. The manger of such a centre is to see that his unit operates at full capacity and contribution is maximum.

5. Investment Centre:

A centre which is concerned with carrying an adequate return on investment is known as investment centre. It is a centre in which a manager can control not only revenues and costs but also investments. The manager of such a centre is made responsible for properly utilizing the assets used in his centre.

He is expected to earn a requisite return on the amount employed in assets in his centre. Return on investments is used as a basis of judging and evaluating performance of various people. Many large undertakings in the U.S.A. like General Motors etc. follow this system of management control.

In calculating return on investments, beginning-of-period investment, end of period investment or average investment may be taken. However, the choice seems to be between beginning-of-period investment and average investment. Divisional investment is equal to net fixed assets of the division + current assets of the division — current liabilities of the division.

$$\text{Return on Investment (ROI)} = \frac{\text{Net Profit of the Division}}{\text{Investment of the Division}} \times 100$$

As an alternative to return on investment, the performance of the responsibility centre can be measured by another method known as residual income method. Under this method a charge for the use of assets (i.e., cost of capital) is deducted from the divisional or responsibility's centre profit and the surplus remaining after the deduction of cost of capital or imputed interest is the residual income.

Residual income method is favoured in those cases where managers of responsibility centres are autonomous and accountable for their performances and make their own investment decisions.

Objectives of Transfer Pricing

1) Profitability

The transfer pricing should pay close attention to the profitability of both the divisions of the organizations. Since both, the divisions belong to the same firm. Thus the items, goods, and services can be configured at any arbitrary price.But, if you want to the profit margins of both the divisions to stay unaffected, it would be a great idea to keep the prices as close to the market prices as possible.

2) Taxation

The transfer price will also have a bearing on taxation. A proper transfer pricing will help you offset the tax liability of one division with an equivalent one on the other. One of the major objectives of the transfer pricing is to maximize the overall tax profits of your organization. The transactions are not governed by open market considerations. This helps you improve upon the taxation options.

3) Goal Congruence

The transfer pricing should be configured in such a manner that the divisional earnings of each of the divisions are quite consistent with the goals of the parent company. The focus should be such that the profit margins of the subdivisions increase while it will not affect the total profitability of the parent organization.

Transfer pricing needs to be configured in a way where the company profits as a whole also improve.

4) Performance evaluation of individual units

Transfer pricing can be one of the best options to arrive at the best possible appraisal of the individual divisions. This can help guide efficient decision making.

Some of the areas that transfer pricing can assist the performance appraisal, and performance management includes appraising the managerial performance of the divisions, evaluation of the contributions of the individual entities for the overall profits of the company, and assessment of the worth of each division as an individual unit.

5) Taking a good look at international trade

Another prime objective that transfer pricing aims to achieve is to measure the international trade scenario. The pricing should be in tune with the import and export standards and should be accurately measured.

Too low a price can distort the international trade figures to a greater extent. The transfer pricing prices should be such that they will not distort the international trade figures.

6) Shifting of profits

Profit shifting is aimed at reducing the tax liabilities in a particular country can be reduced. This can be achieved by reducing profits artificially. It is also aimed at decentralization of the production so that the profits are concentrated enough in the region where the production of the goods is undertaken.

Some other objectives of transfer pricing

while the transfer pricing needs to take care of the major objectives as outlined in the above discussion, it also has a few other essential objectives to fulfill. A few of the other objectives laid out in a simple to understand language include-

- Reduce the customs duty payments since the transfer is between the two division of the same parent organization. This will help reduce the pricing so that your products will stay in tune with the market prices.

- Transfer pricing assists you in circumventing the restrictions on the import quota restrictions. This helps you import the items without any restrictions.
- Letting you transfer the funds to locations to aid in corporate funding standards.

Multinational Transfer Pricing

In setting a multinational transfer pricing, a company will usually concentrate on satisfying a single objective, namely: **"**minimize income taxation**"**.

The four objectives stressed for domestic transfer pricing—goal congruence, motivation, autonomy, and performance evaluation—are considered secondary**.**

In their study for the National Association of Accountants, Benke and Edwards asserted that **"*the advent of U.S.-based multinational corporations and their continued growth have added another, more complicated dimension to transfer pricing*"**.

This post illustrates the economic benefit to a company of using a favorable transfer pricing to shift profit from a country with an unfavorable tax structure to one with a favorable tax structure. Enjoy!

Transfer Pricing in Multinational Companies!

The creation of foreign subsidiaries and bases of operation for cross border flow of products, services, trademarks, funding and technology is having a significant impact on the issue of transfer pricing in today's international business scenario. The transfer pricing problem for multinationals is of great significance. There are different income tax rates in different countries. So, it becomes desirable from the view point of overall corporate strategy to show higher profits in low-tax countries and lower profits in high-tax countries. One way to do so is through transfer prices.

There are two basic issues relating to transfer prices in case of multinational companies having divisions in different countries:

1. Income Tax Rates:

Multinational companies always consider domestic and foreign income tax rates while setting transfer prices. For instance, suppose an Indian company based in India has a division in Australia. The Indian division manufactures a component which is transferred to Australian division for assembly and sale of the final product. Assume, the income tax rate in India is higher than the income tax rate in Australia. The different income tax rates will influence the transfer price for the component.

Suppose, the management of the company sets a lower transfer price for the component, this will result in lower profits for the Indian division because transfer prices become revenue for this Indian division. However, the lower transfer prices will produce high income for the Australian division because transfer prices will be cost for the Australian division.

Since the tax rate is lower in Australia, the overall company will save on income tax. The company, by setting a low transfer price, tends to shift a portion of its income to a country having lower tax rate. In some countries, there are regulations and laws prohibiting such transfer pricing practices.

2. Import Duties:

Transfer pricing policies followed by multinational companies are affected by import duties or tariffs. These are the fees charged to an importer generally on the basis of the reported value of the goods being imported. Consider the above example again of a multination firm with divisions in India and Australia.

If Australia imposes an import duty on goods transferred in from the Indian division, the company has an incentive to set a relatively low transfer price on the transferred goods. This will reduce the duty to be paid and maximize the overall profit for the company as a whole. Like income taxes, countries sometimes make laws to restrict multinational firms' flexibility in setting transfer prices to minimize import duties payable by them.

Factors Affecting Multinational Transfer Prices

The following considerations are used by multinational companies for deciding transfer pricing policy:

(i) Transfer Prices as a Tool to Minimize Worldwide Taxes, Duties and Tariffs:

Transfer prices may be set between two subsidiaries of a holding company and/or two units of a corporate body in such a way to minimize the taxes, duties and tariffs on their overall profit. For example, suppose, tax rate on profit in country X is lower than in country Y. The subsidiary in Y will then under invoice its export to the subsidiary in X. The profit at the latter subsidiary will be inflated, but that will bear a lower tax burden.

(ii) Avoidance of Financial Restrictions on Profit Repatriation Imposed by Government:

When in a country, financial restrictions on profit repatriation is imposed by Government, transfer prices is set among two subsidiaries by over invoicing its imports. In some countries there may be restriction on repatriation of income and dividend/profits. Goods are sought to be transferred to subsidiaries in these countries at more than the price otherwise settled at arm's length.

(iii) Avoidance of Divisional Conflicts:

Transfer prices are set among the units in such a way that general co-ordination between units are promoted, the implementation of appropriate procedures to ensure, as far as possible, uniformity in the classification and application of costs are maintained and divisional conflicts among different units are reduced.

(iv) Overall Goal Congruence:

Transfer prices should help achieve overall goal congruence with regard to profit/income and customer satisfaction.

(v) Inflation:

If a country hosting a subsidiary, has a high rate of inflation, early repatriation of fund is done by overcharging goods, exported to it so that money may not be tied up in a currency that depreciates. However, the tax and fiscal authorities of the host countries are vigilant. They impose penalty for manipulated evasion of taxation or import duties. To safeguard the position, the taxpayer may enter into an advanced pricing agreement with the related two tax authorities.

Besides the above considerations, multinational companies have different internal and external objectives of transfer pricing policies, as displayed in Exhibit 12.6.

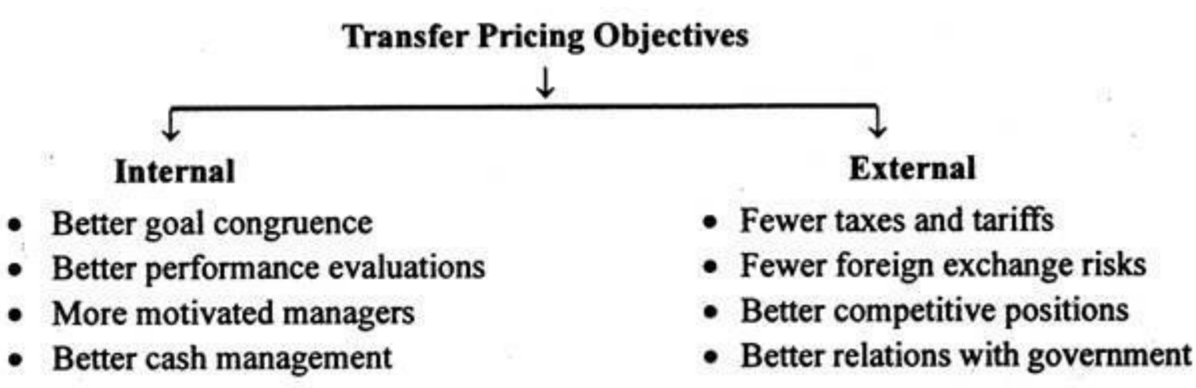

Exhibit 12.6: Multinational Company Transfer Pricing Objectives.