

What is Transfer Pricing?

Worksheet

Transfer pricing sets the internal price for goods/services moved between divisions, typically using market-based, cost-based, or negotiated methods.

$$\text{Transfer Price} = \text{Cost} + \text{Markup (or Market Price)}$$

Questions

1. Which transfer pricing method uses the price charged to outside customers?
 - A) Cost-based
 - B) Market-based
 - C) Negotiated
 - D) Standard costing
2. A transfer price is set at variable cost plus a markup. This is the
 - A) Market-based method
 - B) Cost-based method
 - C) Negotiated method
 - D) Dual pricing method
3. Negotiated transfer prices are typically bounded by
 - A) Zero and infinity
 - B) The buyer's fixed cost only
 - C) The seller's cost floor and the market ceiling
 - D) Government-set tax rates
4. Why does transfer pricing matter for multinational companies?
 - A) It has no tax impact
 - B) It only affects internal reporting, never real cash
 - C) It can shift reported profit between tax jurisdictions
 - D) It determines employee salaries
5. Division A's variable cost per unit is \$50, agreed markup is 20%. Find the transfer price.
6. An external market sells the same component for \$75. Under market-based transfer pricing, what price should Division A charge Division B?
7. Two divisions negotiate a transfer price between the cost floor (\$40) and market ceiling (\$70), settling on \$55. Confirm this is valid.
8. Define: What is transfer pricing?
9. Define: When is market-based transfer pricing preferred?
10. Define: What is a downside of cost-based transfer pricing?

Answer Key

1. B) Market-based - Market-based pricing mirrors what external buyers pay.
2. B) Cost-based method - Cost-based methods start from the selling division's cost, then add a markup.
3. C) The seller's cost floor and the market ceiling - Negotiation happens between the seller's minimum acceptable price (cost) and the market's maximum (external price).
4. C) It can shift reported profit between tax jurisdictions - Transfer prices move profit between divisions/countries, which is why tax authorities scrutinize them closely.
5. $TP = VC + \text{Markup}\% VC = 50 + 0.20 \cdot 50 = 50 + 10 = \60
6. Market-based method uses the external market price directly $TP = \$75$ (the price outside customers pay)
7. Negotiated price must satisfy: Cost \leq TP \leq Market price
Check: $40 \leq 55 \leq 70$ valid negotiated price
8. The internal price charged between divisions of the same company for goods or services transferred.
9. When a competitive external market price exists - it reflects true opportunity cost.
10. It can hide the selling division's inefficiencies since costs are simply passed along, sometimes with a markup.

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