MANAGERIAL DECISIONS RELATED TO TRANSFER PRICES

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Inside decentralized organizations, the managerial control system belonging to different under units often uses transfer prices in order to coordinate the under units actions and for evaluation of their performance. The transfer prices are the prices cashed by a unit for the products sold to another unit. The criteria used in price evaluation are: congruency of targets, managerial effort, under unit performance evaluation and under department autonomy As concerns the transfer prices, the superior managers must evaluate the following aspects: the unit can be supplied from exterior sources so long as the same goods are available inside the unit, and also the price is the same as for the transfer achievement. The decisions the managers must take concern the calculation methods of transfer prices and also concerning the litigation solving modalities. The transfer prices can be based either on the market or on the costs, or they can be negotiated.

Key words: *transfer prices, managerial control system, decisions*

A transfer price is the price that a sub-unity (department or division) applies for a product or service supplied to other sub-unity from the same organisation [1]. The prices practiced between affiliated persons (the Romanian Fiscal Code considers that two companies are affiliated if one of them holds a minimum of 25% of the equity interests or vote right or even the control of the other sub-unity) [6] for the transactions between them as sale of products (for example, a company who manufactures tractors has a separate division who produces engines, the transfer price is the one at which the division transfers the engines to the company who manufactures tractors), services, transmission of intellectual property rights or the performance any other transactions represent a more and more important aspect both for the companies involved and to the fiscal authorities from those countries, especially in cases in which the components of the group develop their activity in different countries, and the "unwritten" rule is that according to which the profits will be transferred to the country with the most relaxed fiscal system.

MATERIAL AND METHOD

From a theoretic point of view, the prices applied for the transactions within the group represent a simple and handy modality of the companies members of a group to re-allot their profits and losses according to the objectives followed at the central level. The transfer prices generate income for the unity who sells also acquisition costs for the unity who buys them, affecting in this way the operating profit of each unity involved in the transaction. These operating profits are thus used in order to assess the results of the unities but also to motivate the managers. In case the companies, members of a group, are located in different countries, then the decisions of the group can influence the fiscal position from every country in which they activate.

In order to avoid such situations which would finally lead to a decrease of the tax on profit due, the transfer prices are legally regulated. Romanian law relatively recently adopted according to the Guide of the Organisation for Economic Cooperation and Development (the international legal base regarding the transfer prices on the grounds of which 90% of national laws related to this aspect have been drawn up) provides that the transactions between affiliated persons will be accomplished complying with the free market principle according to which the transactions must be performed in the conditions established or required which must not differ from the commercial or financial relations established between independent enterprises.

RESULTS AND DISCUSSIONS

The market value principle was introduced for the first time in Romanian law in 1994, but only in 2004, when the Fiscal Code entered into operation, all the elements necessary to establish the transfer prices have been defined: the definition of affiliated persons, the market value principle, and also the methods to establish the transfer prices. By the Governmental Decision number 529/2007, the procedure for the application of an anticipated fiscal solution has been approved. The agreement on advance payments through which one may establish the method to determine the transfer prices is valid for a period of five years and can be extended if the same conditions are fulfilled for a period of five years or can extended in order to introduce new conditions. The price requested by National Agency for Fiscal Administration is between Euro 10.000 and 20.000, and for the amendments to the Agreement the price is between Euro 6.000 and 15.000.

In establishing the transfer prices, one must take into consideration not only the internal requests of the companies within the group or of the sub-divisions within the same company, but especially the fiscal regulations of each country in part. Consequently, one must keep in mind not only the review and substantiation of the transfer price policies at the level of the group, but also the fact that a specific and complete documentation must be drawn up in order to demonstrate the market value of the prices applied within the transactions in the interior of the group.

The fiscal authorities investigate mainly the transactions performed by a Romanian company with an affiliated foreign company. Until now, there is no formalization of the requests regarding the transfer prices in Romanian law. If the prices used within the transactions between affiliated parties do not comply with the free market principle, the fiscal authorities are entitled to re-calculate the income and the expenses of the company in order to reflect on the transactions at the market value.

The lowest or the highest degree of decentralization and of delegating the responsibility to the managers of sub-unities may determine also the strategy on the transfer prices of each company group. The manager of each sub-unity must first follow the interest of the unity under his responsibility and to obtain a high degree of profitability, and at the same time to take into consideration the interests of the organisation. Thus, the economical results and the financial performances of the organisation must be taken into consideration both by the managers of inferior levels and by top managers, and the transfer of the profit and of the fiscal burden within the group must take into consideration the most convenient tax level, complying with national and international laws on transfer prices.

While rates of the tax on profit have been decreases, in a trap to attract as many foreign investors as possible (for example, Cyprus – 10%, Ireland – 12.5%, Latvia and Lithuania – 15%, Hungary and Romania – 16%), the prevention of the transfer of taxable profits in favourable jurisdictions from the fiscal point of view, has become a priority of governments [5].

The multinational companies, who theoretically develop their activity on the territory of different countries, are most of them decentralised due to the fact that in this way the managers from different countries can take decisions taking into consideration the knowledge related to local political economic environment (language, custom, culture, laws, and specific economic practices). As a rule, the largest multinational companies proceed to a rotation of the managers, in the sense that the managers of the centres from abroad are at their turn brought to the central head office and vice versa, in order to study more deeply the main objectives of the company and to follow the congruency of the objectives proposed both at the central and at the local level. On one hand, a too deep decentralisation has a series of disadvantages because not always the managers from abroad prove to be fully loyal to the company and there were many cases when frauds of millions of Euro have been stolen due to the fact they were given too much liberty.

The calculation of transfer prices is performed by means of three methods, namely:

- *Method of transfer prices based on market:* the managers choose to establish the prices at the value determined for external clients or according to the prices posted for similar products by competition companies; on the markets with perfect competition, the minimum price at which the supplying division can sell is the market price because at any moment the latter will be able to sell its products abroad, and the minimum price that the division who buys can pay is also the one established by the market, because the latter has the possibility to get supplied from somewhere else; in situations of crisis, the transfer prices are based on the medium long-term prices of the market (normal prices), but if the latter are much higher than the crisis prices, there is the risk that the managers take the decision to take supplies from abroad;
- *Method of transfer prices based on costs:* the managers can choose to establish the transfer prices at the level of the costs of that specific product, being either an effective cost of a budget one. As a base, one my use variable production costs, variable and fix costs, and complete costs; the

transfer prices based on costs prove to be useful when the market prices are accessible or it costs too much to obtain them, as it happens in the case of specialised products or of those products which are very different of those which can be found abroad from the point of view of the quality and customers;

- *Method of negotiated transfer prices*: most often, these prices are used by managers when the market prices and unstable. The negotiated transfer price is the result of a negotiation process between the sub-unities who sell and those who buy.

The studies show that in order to calculate the transfer prices at the internal level, the managers from all countries use more often the transfer prices based on costs than those based on market. In order to calculate the transfer prices at international level, the managers use both the methods based on market and those based on costs. Many multinational companies have transfer prices based on market in some divisions and transfer prices based on costs in other divisions [1].

In the process of assessing the transfer prices, a series of four criteria are used at international level and namely:

- Congruency of objectives: the performance of each centre should lead to the optimisation of the company in its entirety;
- Managerial effort: represents the actions developed within the scope of achieving an objective;
- Assessing the performance of the division: in order to measure the performances of the centres within a multinational company, the managerial control system uses a type or a combination of the four types of responsibility centres: cost centre – the manager is responsible only related to the costs; income centre – the manager is responsible only related to the income; profit centre – the manager is responsible both by the income and by the costs; investment centre – the manager is responsible by investments, income and costs.
- Autonomy of the division: the managers of the centres from abroad should have the possibility to choose between buying from other centres of the company or from the exterior if this action is in the advantage of the sub-unity.

The method by which the transfer price is obtained based on the market complies, to a great extent, with the four criteria. Thus, the congruency of the objectives, the assessment of sub-unities and the maintenance of the autonomy can be obtained only in the condition of a competitive market while the support of the managerial effort takes place irrespective of the market on which the latter activates.

The method by which the transfer price is obtained based on costs often but not always ensures the congruency of the objectives, the assessment of the performances of the sub-unity can be obtained only if the transfer prices exceed the complete costs, and the managerial effort is supported only based on budget costs, because the motivation to perform the controls decreases if the transfers are based on effective costs, and the principle of the sub-unity's autonomy cannot be complied with as long as it is based on a regulation. En exchange, this method is useful for the determination of complete costs for products or services being very easy to implement.

The method by which the transfer price is obtained by negotiation between the two centres (the one who sells and the one who buys) leads to the congruency of objectives proposed both by the company and by the company in its entirety, the assessment of the unity's performances can be accomplished, but the transfer prices are influenced by the abilities of the managers of the sub-unities to negotiate, the support of the managerial effort is a respected principle, and the autonomy of the sub-unity is maintained because the entire process to establish the transfer prices is developed based on negotiations.

CONCLUSIONS

The decisions that the managers of sub-unities must take in connection to the transfer prices refer to the following aspects:

- Can the managers chose goods from the exterior as long as these products are manufactured within the group?
- Which will be the transfer price?

In order to clarify these aspects, one must first choose the calculation method of the transfer prices, and also the manner to calm down the litigations (by negotiation, arbitrage or other directives of the management depending on the degree of decentralisation of the organisation). Due to the fact that the calculation of the transfer prices re-allots the profits between divisions, the competition often appears between the managers of the divisions, fact which determines a low interest on the exchange of information, causing in this way damage to the organisation.

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