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Main article

The teaching of transfer pricing: Theory and examples

Mark Tippett [a,*], Brian Wright [b,1]

[a] Business School, Loughborough University, Leicestershire, United Kingdom
[b] School of Business and Economics, University of Exeter, Devon, United Kingdom

Abstract

This paper presents a unified framework for teaching transfer pricing at the advanced undergraduate or Masters levels. The approach is based on the economic transfer pricing model of Hirshleifer [Hirshleifer, J. (1956). On the economics of transfer pricing. *Journal of Business, 29* (July), 172–184; Hirshleifer, J. (1957). On the economics of the divisionalized firm. *Journal of Business, 29* (April), 96–108] but uses a series of numerical examples to "flesh out" the principles arising from the purely diagrammatic approach taken by Hirshleifer. We also develop numerical examples that illustrate the effects that removing the frictionless markets assumptions (that underscore the Hirshleifer approach) can have on optimal transfer pricing rules. The focus here is on the lack of goal congruence introduced by agency considerations and the role of accounting procedures in alleviating these agency issues. The teaching materials embodied in this article were developed "at the coalface" and have been successfully used by the authors in advanced undergraduate managerial accounting classes.

Keywords: Transfer pricing; Divisionalized firm; Cost and demand independence

1. Introduction

The topic of transfer pricing is a mainstay of almost every advanced undergraduate course in managerial (or cost) accounting. The typical textbook approach is to consider, in a heuristic fashion, the setting of transfer prices on an "economic basis" and then to

* Corresponding author. Tel.: +44 1509 228829; fax: +44 1509 223960.
E-mail addresses: M.Tippett@lboro.ac.uk (M. Tippett), B.Wright@exeter.ac.uk (B. Wright).
[1] Tel.: +44 1392 263480; fax: +44 1392 263201.

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discuss alternative techniques such as cost-plus based transfer prices, negotiated transfer prices, and tax-efficient transfer prices. The economic approach is invariably considered as the "benchmark" against which these alternative transfer pricing policies should be evaluated. Given this, it is crucial that students have a good understanding of the economics of the transfer pricing problem, since without it they will have difficulty in obtaining a full appreciation of the costs and benefits associated with the alternative transfer pricing policies suggested in the literature.[2]

In the following sections, we develop the economic transfer pricing model in a form which, we have found, allows students to master the fundamental principles of the transfer pricing problem with little difficulty. Our approach is motivated by the seminal papers of Hirshleifer (1956, 1957) and in particular, the price theoretic (marginalist) approach to the transfer pricing problem on which those papers are based. However, our experience is that students often have difficulty in interpreting both the concepts and the optimization procedures that lie behind this price theoretic approach and that it is not until these concepts and procedures are demonstrated in terms of some numerical examples that students can fully comprehend them.

Given this, our approach to the teaching of transfer pricing is based on a series of numerical examples which, starting with the simplest possible market scenario, are gradually developed into the more complicated market settings that one would expect to find in practice. These numerical examples are distributed to our students in note form several days prior to class and are initially worked through in a lecture (large group) class setting. The large group classes are supplemented by small groups (maximum 15 students) in which students work through a set of numerical problems based on the examples introduced in the (large group) lectures, under the supervision of a tutor (instructor). As a rule, we give class materials and example questions on transfer pricing to students some days prior to each class. We have found that this allows students to absorb the definitions of the mathematical symbols used in the examples, and gain a "feel" for the style of the arguments. This then allows them to focus critically on the economic concepts during the class.

We spend some time ensuring that our students have a clear and detailed understanding of the Hirshleifer approach, through the practical examples. It has been found that this attention to detail in the fundamental economic model facilitates a deeper understanding of actual accounting practice. Once the marginalist approach to the transfer pricing problem has been firmly established in our students' minds, its merits and limitations are then evaluated against the more discursive material on transfer pricing one normally finds in the text books of the area (Atkinson, Banker, Kaplan, & Young, 2001, Chap. 12; Horngren et al., 2005, Chap. 18). It is well known, for example, that the assumptions on which the marginalist approach relies are unlikely to hold up in practice and it often

[2] The 1999 Practice Analysis of Management Accounting reports that management accountants now spend the bulk of their time on strategic planning, internal consulting, process improvement and performance evaluation (Siegel & Sorensen, 2003). The time spent on repetitive procedures traditionally associated with management accounting (e.g. preparing and presenting standardized reports, routine product costing, resource management) is steadily declining. Given this, it is hardly surprising that, after extensive consultation with curriculum experts, professional accounting bodies and accounting practitioners, the 1999 Practice Analysis of Management Accounting lists transfer pricing as one of 30 core competency areas for practising management accountants. For management accountants in "large" corporations the globalization of the world economy means that transfer pricing is of increasing strategic importance and is far more complicated than it has been in the past.