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# Strategic transfer pricing in a marketing-operations interface with quality level and advertising dependent goodwill

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## Abstract

Determining an appropriate transfer price is of importance to a firm composed of divisional profit centers since it significantly affects decision-makings of each profit center and then the firm's profit. In this paper, we investigate the effects of negotiated and administered transfer pricing on the profits of each center and the firm based on a differential game involving an operations department and a marketing department within a firm. The operations department is responsible for the quality improvement of a particular product and sells this product to end customers through the marketing department who controls the retail price and advertising effort. Our results suggest that compared with the administered transfer price, the negotiation between the operations department and the marketing department leads to a higher transfer price, and then a higher retail price, lower advertising effort and higher quality improvement effort. What's more, the decentralized departments can be coordinated by a committed dynamic transfer price of the operations department, and both departments and the firm can benefit from this coordination.

*Keywords:* Quality, Advertising, Goodwill, Transfer price, Differential games

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## 1. Introduction

In today's business world characterized by growing complexity of modern firms, decentralized decision-making has become a trend due to its distinct advantages in using available information directly and dealing with the unexpected shocks quickly and flexibly. Many firms have developed divisional organizations to exploit these benefits of decentralization, where some or all of the separate divisions are visually autonomous profit or cost centers [1]. When the goods and services are exchanged between divisional centers, transfer pricing comes into being, and the amount of money that the buying profit center pays to the selling profit center is referred to as transfer price. This internal price plays an important role in directing decision-makings and coordinating profits for each center and the firm as a whole.

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