ROLE OF AN ACCOUNTANT IN DECENTRALIZED TRANSFER PRICING AND PERFORMANCE MANAGEMENT

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Abstract
Decentralization is a systematic effort to delegate to the lowest levels of all authority except that which can only be exercised at central point and transfer pricing while performance management has been one of the most important and positive developments in the sphere of human resource management in recent years. The accountant segregates the revenue and costs into areas of personal responsibility to assess the performance attained by persons to whom authority has been assigned in the organization. It is used to measures evaluate and monitor decentralization process. In this paper, we examined the role of an accountant in decentralized transfer pricing and performance management. We demonstrated that seemingly unprofitable strategy of decentralizing price-setting decisions actually makes sense when considered in a strategic context, incorporating its impact on industry profitability. Again, transfer prices as the internal price of products created within the company have two main functions profit allocation and coordination. In addition, the various types of transfer pricing that exist are examined in view of these functions such as market-based, cost-based and negotiation transfer pricing. Overall, we found that transfer pricing is generally considered as the major international taxation issue faced by multinational corporations and is an enormously important issue for many countries, though responses to it will in some respects vary.
Keywords: Transfer pricing; Performance management; Cost; Market price; Decentralization

Introduction

As organizations grow and undertake more diverse and complex activities, they face decisions about how much decision-making authority to delegate to lower levels of the organization. An organization's structure evolves as its goals, technology, and employees' change, and the progression is typically from highly centralized to highly decentralized. When top management retains the major portion of authority, centralization exists. Decentralization refers to top management's descending delegation of decision-making authority to subunit managers. Abbott Laboratories recognizes the need for decentralization in its corporate structure because the company's global operations demand that the managers on location in any particular region be able to most effectively use corporate resources (Dean, 2019).

When all the segments of a decentralized organization are independent of one another, segment managers can focus only on their own segments because what is best for their segment is generally best for the organization as a whole. In contrast, when segments interact, such as buying or selling in the same markets, there is a possibility that what helps one segment damages another segment badly enough to have a negative net effect on the entire organization. The more customers (and supplier) two segments have in common, the more a company should consider combining the two segments into one to minimize dysfunctional incentives for one segment to gain at the expense of the other. Other potential interactions between segment and organizational interests occur when one segment sells products or services to another segment of the same organization for a price called the transfer price. For example, when one segment produces a component and sells it to another segment that then incorporate the component in a final product, a transfer price is required.

Transfer pricing policies are especially important in decentralized companies where top management believes that segment autonomy has important benefits. In such companies, segment managers decide how many products or services will be transferred from one segment to another. Delegating these decisions to segment managers creates benefits when the segment managers, being "closer to the action, "have better information than top management about the items being transferred. According to Aryva, and Mittendorf, (2017). The challenge to such companies is to design a transfer pricing policy that motivates segment managers to transfer the quantity of products and services that both maximizes the segment's profitability metric and is also in the best interests of the company as a whole.

Performance management is about managing an organization which one of the duty of the accountant. It is a natural process of the accountant, not a system or a technique (Fowler, 2020). It is also about managing within the context of the business, namely its internal and external environment. This will affect how it is developed, what it sets out to do and how it operates. The context is very important to the organization, and Jones (2015) goes as far as to say manage context, not performance. Performance management concerns the accountant role in the business not just managers. It rejects the cultural assumption that only managers are accountable for the performance of their teams and replaces in the organization, it with the belief that responsibility is *shared* between managers, team members and the accountant. In a sense, the accountant should regard the people who report to them as customers for the managerial contribution and services they can provide. The accountant and its teams are jointly accountable for results and are jointly involved in agreeing what they need to do and how they need to do it in the organization, in monitoring performance and in taking action. Performance management processes are part of a holistic approach to managing for performance, which is the concern of the accountant in the organization.

Performance management is a means of getting better results from a whole organization, or teams and individuals within it which the accountant have a vital role to play in order to achieve this, by understanding and managing performance within an agreed framework of planned goals, standards and competence requirements.

Recent studies of transfer pricing in the accounting and management literature emphasizes that the problem arises due to decentralization of firm activities and products (Lantz, 2019). Decentralization brings several benefits such as overcoming the limited information processing capabilities of the headquarters, reducing the cost of control, providing better incentives for subsidiaries, and so on. However, decentralization also brings costs along benefits, namely, subsidiaries maximize their own branch profits, even if such actions may reduce total firm profitability. Due to these benefits and costs of decentralization, the central management desires decentralized-centralization. That is in order to reap the benefits and alleviate the costly behavior, it uses transfer pricing to manage different subsidiaries, and to maximize the total firm profits. Empirical studies by Wu and Sharp (2019) support this view. They found that profit maximization of the whole firm and performance evaluation of the subsidiaries were the dominant objectives for transfer pricing.

In view of the above, it becomes necessary to transfer some management functions to subordinate managers leading to some form of decentralization, that is delegating authority for decision making to other levels of management. This is other wise known as divisionalisation. It is the division of a business into autonomous regions or product business. Each division has its own revenue which might be a subsidiary company under the head office or profit centre/ investment centre within a single company. In practice, it's impossible to have either a completely centralized organization or a completely decentralized organization. The basic purpose of transfer pricing is to induce optimal decision making in a decentralized organization (i.e., in most cases, to maximize the profit of the organization as a whole). In this study, we investigate the role of the accountant in the decentralization of the transfer prices and performance management.

Literature Review and Theoretical Framework

Decentralization

Decentralization refers to tire systematic effort to delegate to the lowest levels all authority except that which can only be exercised at central point. According to Louis A. Allen, Decentralization also means the division of a group of functions and activities into relatively autonomous units with over authority and responsibility for their operation delegate to time of cacti unit. Decentralization is simply a matter of dividing up the managerial work and assigning specific duties to the various

executive skills. Thus, decentralization is concerned with the decentralization of decision-making authority to the lower levels in managerial hierarchy (Cook, 2018).

Firms with multiple responsibility centers usually choose one of two approaches to manage their diverse and complex activities: centralized decision making or decentralized decision making. In centralized decision making, decisions are made at the very top level, and lower-level managers are charged with implementing these decisions. On the other hand, decentralized decision making allows managers at lower levels to make and implement key decisions pertaining to their areas of responsibility. Decentralization is the practice of delegating or decentralizing decision-making authority to the lower levels. Organizations range from highly centralized to strongly decentralized. Although some firms lie at either end of the continuum, most fall somewhere between the two extremes, with the majority of these tending toward a decentralized approach. A special case of the decentralized firm is the multinational corporation (MNC). The MNC is a corporation that "does business in more than one country in such a volume that its well-being and growth rest in more than one country."

Performance reports are the typical instruments used in evaluating efficiency and effectiveness. Profit centers are evaluated by assessing the unit's profit contribution, measured on income statements. Since performance reports and contribution income statements have been discussed previously, this chapter will focus on the evaluation of managers of investment centers.

Reasons for Decentralization

Seven reasons why firms may prefer the decentralized approach to management include better access to local information, cognitive limitations, more timely response, focusing of central management, training and evaluation of segment managers, motivation of segment managers, and enhanced competition. These reasons for delegating decision-making authority to lower levels of management.

Advantages and Disadvantages of Decentralization

Advantages

- Decisions are better and more timely because of the manager's proximity to local conditions.
- Top managers are not distracted by routine, local decision problems.
- Managers' motivation increases because they have more control over results,
- Increased decision making provides better training for managers for higher level positions in the future.

Disadvantages

- Lack of goal congruence among managers in different parts of the organization.
- Insufficient information available to top management; increased costs of obtaining detailed information.
- Lack of coordination among managers in different parts of the organization.

2.4 Benefits of Decentralization on Planning and Control

In analyzing the effect of decentralization, we tend to look at the changes that decentralization has brought in relation to planning and control in an organizational setup which includes:

1. Senior management is relieved from trivial matters leaving them with more time for overall review
2. Speed in operational decisions as the manager at the division swiftly reacts to changing local circumstances.
3. Provision of better training ground to junior staff who aspire to be at the topmost level of the organization.
4. Encourage initiatives and motivates managers
5. Increases flexibility and reduces communication gap.
6. Encourages sub-optimal decision making.
7. Appointment of overhead cost into individual profit centers
8. Introduction of appropriate recording and measuring procedures.

However, in the decentralization of planning and control top management often retain some control and decision while others are delegated. Some of the decisions, planning and controls retained by top management are:

- Appointment of senior staff
- Determination of corporate objectives of the organization
- Approval for all major capital expenditure proposals
- Product line closure and departmental closure decisions.
- Monitoring of over all results and settling inter-departmental deputes.
- Centralized services such as legal services
- Decision relating to sourcing of funds and investment of surplus funds.

Transfer Pricing

The term transfer pricing has been defined variously by different authors, Okoye (2007), in his own view, defines transfer pricing as "a price used to measure the value of goods and services furnished by one division to another division within an organization". It can also be defined as "the monetary value attached to goods manufactured by a particular decision-making unit and then transferred to another division for the purpose of being utilized for the divisional final product". While Dean. Feuch and Smith (2008), are of the view that it is "pricing of goods and services

that are transferred between members of corporate family including parent to subsidiary, subsidiary to parent and between subsidiaries".

Transfer pricing as defined by (CIMA) is a price related to goods or other services transferred from one process or department to another or from one member of a group to another. Transfer pricing is necessary in order to appraise the separate performance of the divisions or department. It is used to evaluate the revenue accruing to the selling division and the cost or expenses incurred by the buying division. The general concern of transfer pricing is all about the (1) impact on divisional performance, (ii) impact on firm-wide profits and (iii) impact on divisional autonomy.

Transfer prices are internal charges established for the exchange of goods or services between responsibility centers of the same company. Although a variety of transfer prices may be used for internal reporting purposes, intracompany inventory transfers should be presented on an external balance sheet at the producing segment's actual cost. Internal transfers would be eliminated for external income statement purposes altogether. Thus, if transfers are "sold" at an amount other than cost, any intersegment profit in inventory, expenses, and/or revenue account must be eliminated.

Basically, transfer price can be defined as the price that one segment of an organization sets to sell products or services to another segment of the same organization (Horngren et al., 2014). McAulay & Tomkins (2012) summarized four sets of arguments to prove purposes of transfer pricing. The first argument is functional necessity. Transfer pricing was ascertained to be really important to firms simulating a divisionalized profit center structure as well as to multinational companies. Secondly, according to economic arguments, resources must be allocated to divisions efficiently thanks to transfer pricing. Thirdly, the organizational argument suggested benefits of transfer pricing in boosting integration and differentiation in divisionalized corporations. Lastly, strategic arguments supported the mutual interaction between strategies and transfer pricing policies that might represent as the relationship between strategic formulation and strategic implementation.

Transfer pricing plays an important role in a decentralized organization where autonomy is granted to each segment manager because in this organization, there may be dealings in products or services among segments. For example, in a firm operating in the oil industry, there may be dealings between the petroleum refining division, where produces gasoline, and the retail sales division, where buys gasoline. In each transaction, the transfer price is recorded as sales revenue to the selling segment but a cost to the buying segment; and the profit of each segment will be affected by a change in the transfer price while the whole profit of the firm can be unchanged. A general rule for transfer pricing Although there is no an optimal

transfer price that satisfies all suggested objectives, Horngren et al. (2014) proposed a general rule for transfer pricing as a good benchmark for guidance.

Specifically, Transfer price = Outlay cost + Opportunity cost
In this formula, outlay cost is the amount of money the producing segment has to pay to produce the product or service, and "opportunity cost is the contribution to profit that the producing segment forgoes by transferring the item internally" (Horngren 2014).

Purposes of Transfer Pricing
There are two main reasons for instituting a transfer pricing scheme:

- Generate separate profit figures for each division and thereby evaluate the performance of each division separately.
- Help coordinate production, sales and pricing decisions of the different divisions (via an appropriate choice of transfer prices). Transfer prices make managers aware of the value that goods and services have for other segments of the firm.
- Transfer pricing allows the company to generate profit (or cost) figures for each division separately.
- The transfer price will affect not only the reported profit of each center, but will also affect the allocation of an organization's resources.

Mechanics of Transfer Pricing and Functions in Decentralization

- No money need change hands between the two divisions. The transfer price might only be used for internal record keeping.
- (Transfer Price × quantity of goods exchanged) is an expense for the purchasing center and a revenue for the selling center. The most essential functions of transfer prices are two namely; Profit Allocation and Coordination Function.

Profit Allocation
In decentralized companies, transfer prices are necessary for the determination of the divisions' profits, when there are linked performances between the divisions. On one hand, the transfer price is the (internal) revenue of the supplying division; on the other hand, it indicates the (internal) purchase cost of the buying division. Divisional profit is the basis for decisions of both divisional management and the company's upper management, which uses it for strategic activities or budget allocations. It also serves for the assessment of divisional management's performance. The profit contribution of every division thereby becomes visible, the responsibilities are clearly presented, and cost transparency and cost awareness are promoted.

The determination of divisional success requires an accurate demarcation of the success components, which can be assigned to the different divisions. When

performance is to be measured divisional profits have to be allocated, thus profit allocation is an important function of transfer prices (Schuster, & Clarke, 2010).

Coordination Function

Divisional managers should work hard and make their best efforts in their division. Incentives as given to maximize their divisional profit. This can guide them to make decision that are favourable and profitable from the perspective of their own division, but unfavourable from the view of the company as a whole. The effects of a division's decision on other divisions are externalities that are not considered by their divisional manager.

The transfer prices can now be used to influence decentralized decisions. Assume that the divisional manager is responsible for short-term decisions. The head office announces a transfer price (or a transfer price scheme) to the manager for inter-company transfer of intermediate products. The decision behavior of the manager can be steered by influencing the divisional profit through the transfer price. A higher transfer price in tendency reduces the amount bought in by the purchasing division, to choose another production procedure, or to accept a one-off special order less easily. A higher transfer price can change the producing division's production programme or the production amounts. A similar concept is sometimes described as "goal congruence" and suboptimal decision as "incongruent decisions"' we prefer the abstract term of "coordination (function)" as the goal of different divisions usually will not be 100% identical and the perspective on goals only seems too limited.

Types of transfer pricing

There are three common types of transfer prices, namely market-based transfer prices, cost-based transfer prices (including variable cost–based transfer prices and full cost–based ones), and negotiated transfer prices.

1. **Market-based transfer prices**

When there is an intermediate market for the transferred product or service, market price should be used to determine the transfer price. Garrison et al. (2003) defined intermediate market as "a market in which the product or service is sold in its present form to outside customers". More specifically, Horngren et al. (2014) suggested two situations for calculating the transfer price based on the market price. The first situation is that the producing division can sell its products to external customers without incurring any marketing or delivery costs.

In this case, the transfer price should be equal to the market price because this allows managers from both producing and buying divisions to maximize the profitability of each division. Thanks to that, goal congruence in the organization can be achieved. If the transfer price is less than the market price, the profit of producing division will reduce, or if the transfer price is greater than the market price, the buying division

will purchase products from external suppliers with the lower price (at market price). The second situation is that the producing division has to incur some marketing or delivery costswhen selling externally. At this time, the transfer price should be equal to the market price after deducting the marketing and shipping costs when selling to outside customers. This price was called as market-price-minus transfer price (Horngren et al., 2014). The market-price-minus transfer price is expected to drive best decisions from each division towards the best interests of the company as a whole.

2. **Cost-based transfer prices**

Cost-based transfer prices are generally applied when market prices do not exist. Some firms transfer products or services internally at variable costs whereas others transfer at full cost or full cost plus profit (Horngren et al., 2014). The approach of cost-based transfer prices is easy to understand and convenient to use. However, it still suffers some disadvantages as it easily results in dysfunctional decisions that conflict with organizational goals (Horngren et al., 2014). For instance, in the first case, if the producing segment has positive opportunity costs because of limited capacity, it will not agree to transfer internally so that it can pursue alternative opportunities that might decline the profit of the entire company, or it will be forced to conduct internal trade transactions by top management, but this fact violates segment autonomy.

3. **Negotiated transfer prices**

Garrison et al. (2003) identified a negotiated transfer price as a transfer price with the agreement between the selling and purchasing divisions. They explored that this approach can help to preserve the division autonomy that might lead to benefits of decentralization. Furthermore, because segment managers have more information about potential costs and gains from transferring internally, open negotiation will permit them to make optimal decisions for their own divisions as well as to respond to changeable market conditions flexibly (Horngren et al., 2014). Garrison et al. (2003) and Horngren et al. (2014) utilized specific data to illustrate how to determine the range of acceptable transfer prices that makes an increase in the profits of both participating divisions. Basically, transfer prices through negotiation will be in the range between the minimum transfer price the selling division is willing to accept and the maximum transfer price the purchasing division is willing to pay (Kachelmeier, & Towry, 2012).

Other Types of Transfer Pricing

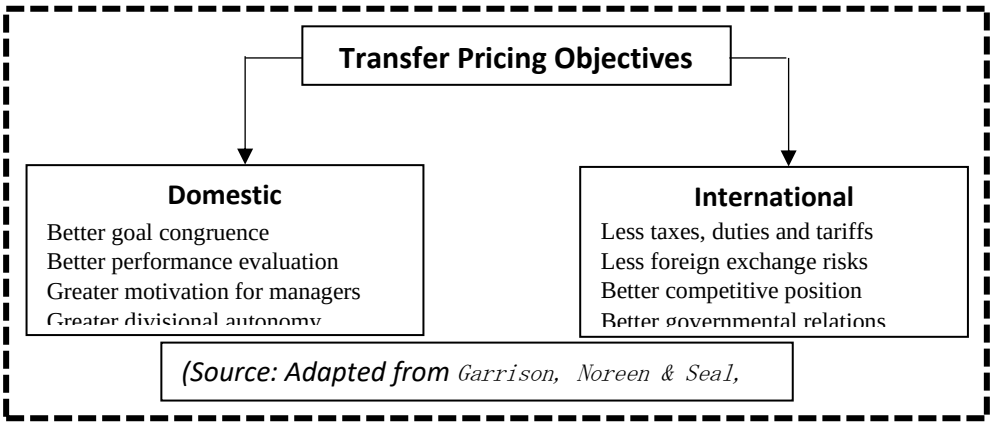
Arbitrary Transfer Pricing Method. Under this method, the transfer price is centrally based on what top management conceived to be most beneficial to the company as a whole. And **Dual Transfer Pricing Method.** It is instructive to noted that no single transfer pricing method is capable to satisfying the three broad objectives of transfer pricing. In fact, it is just not possible to have a single transfer

price. The buying division and the selling division have different interests in the transfer price.

International aspects of transfer pricing

International transfer pricing was identified as "the pricing of goods and services transferred between a company's domestic divisions and foreign subsidiaries or among those foreign subsidiaries themselves" (Tang & Chan, 1979). Main objectives of transfer pricing between in a national company and in a multinational corporation are totally dissimilar. While domestic transfer pricing emphasizes on goal congruence, performance evaluation, motivation for managers, and divisional autonomy, international transfer pricing finds out how to minimize worldwide income taxes, import duties, tariffs, and foreign exchange risks, or how to improve competitive positions as well as relationships among governments (Figure 1). For example, in order to minimize income taxes, a high international transfer price should be set when a division in a low-income-tax-rate country transfers produced items to another division in a high-income-tax-rate country.

Figure 1: Differences in objectives between domestic transfer pricing and international transfer pricing.



Accounting for Transfer Pricing

If intra-company transactions are accounted for at prices in excess of cost, appropriate elimination entries should be made for external reporting purposes. Examples of items to be eliminated for consolidated financial statements include:

- Intracompany receivables and payables.
- Intracompany sales and costs of goods sold.
- Intracompany profits in inventories.

Theoretical Framework

The Role of the Accountant in Decentralization Organization

The accountant segregates the revenue and costs into areas of personal responsibility in order to assess the performance attained by persons to whom authority has been assigned. It is used to measures evaluate and monitor decentralization process. The accountant aims to provide accounting reports to the head office, this enables every accountant to be aware of all the items, which are within his area of authority. Hence, as a system of accounting it distinguished between controllable and uncontrollable cost.

With the accounting process, it is possible to identify or recognize decision centre within an organization for the purpose of tracing costs to the individual managers who are charged with the responsibility of making decision about costs and revenue in the organization. units, this are Cost Center, Profit Center, Revenue Center and Investment Center.

For the accountant to be effective in his or her duties (role) he/she must have the knowledge of operationalization of the transaction, planning and analysis, executive decision support so that he/she can arrive at the mainframe of his/her work. As illustration in figure 2 below, shows the function of the accountant in the organization.

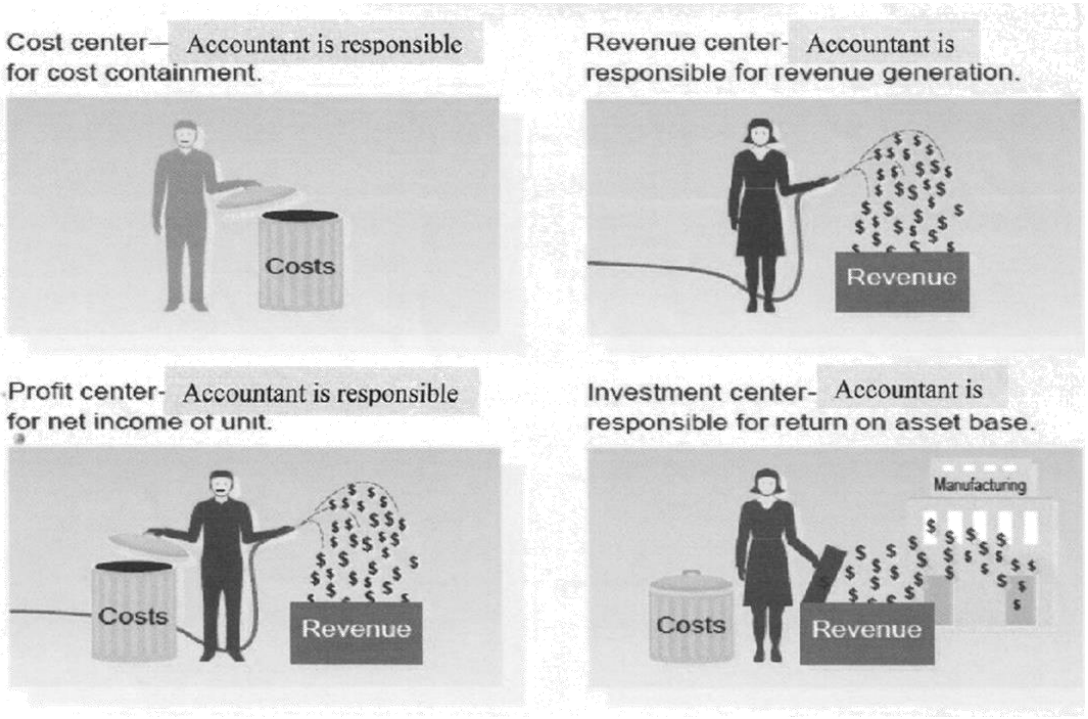


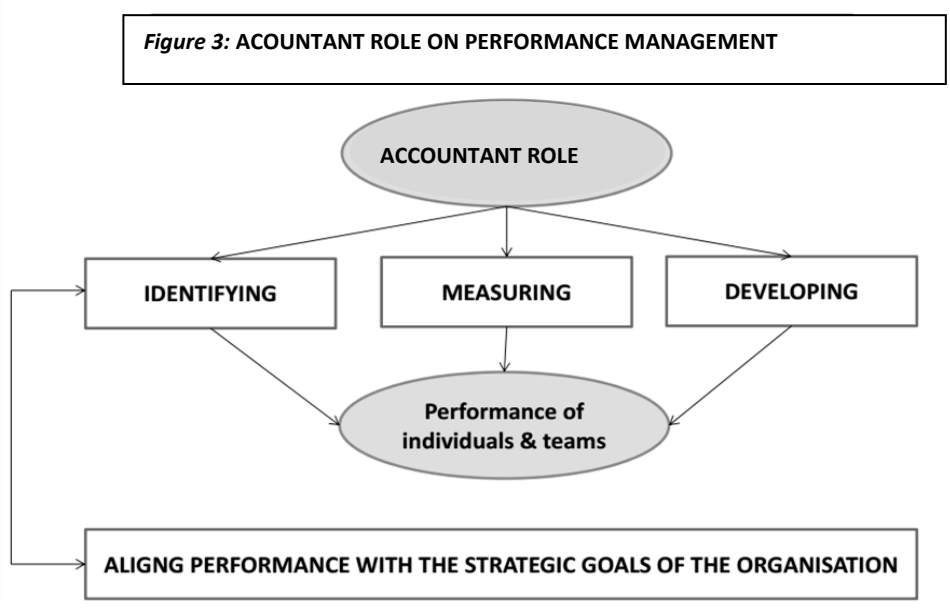
Figure 2: **Shows the Role and Responsibility of the Accountant in the Organization**

Performance Management

The concept of performance management has been one of the most important and positive developments in the sphere of human resource management in recent years. The phrase was first coined by Beer and Ruh (2016). But it did not become recognized as a distinctive approach until the mid-1980s, growing out of the realization that a more continuous and integrated approach was needed to manage and reward performance. For crudely developed and hastily implemented performance-related pay and appraisal systems were all too often failing to deliver the results that, somewhat naively, people were expecting from them. Performance management rose like a phoenix from the old-established but somewhat discredited systems of merit rating and management by objectives.

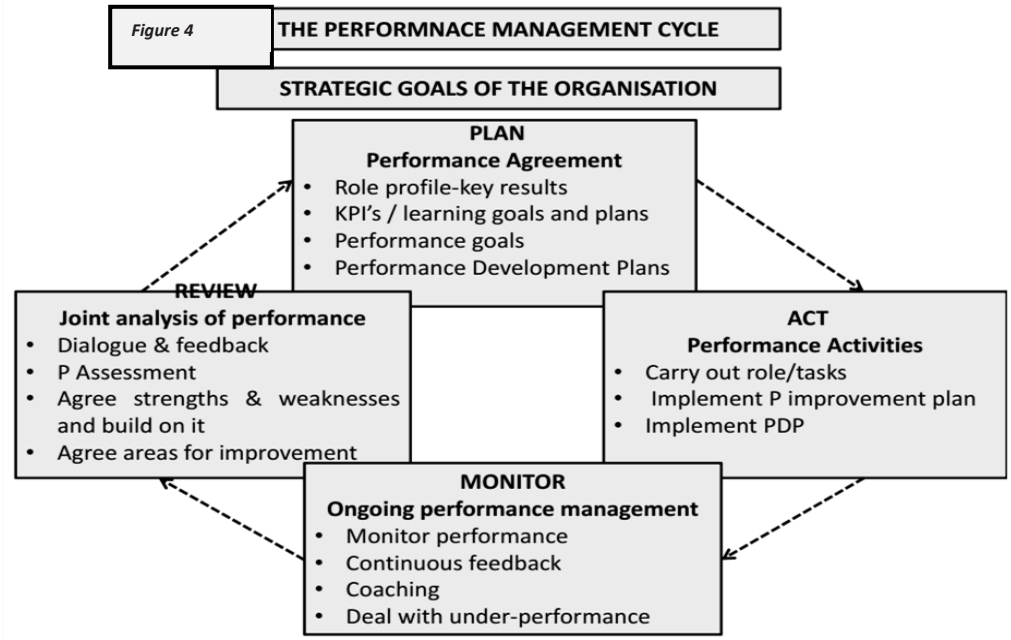
Performance management is a strategic and integrated process that delivers sustained success to organizations by improving the performance of the people who work in them and by developing the capabilities of individual contributors and teams. Performance management is strategic in the sense that it is concerned with the broader issues facing a business if that business is to function effectively in its environment, and with the general direction in which the business intends to go to achieve its longer-term goals. Performance management is integrated in two senses: (1) *vertical integration*, linking or aligning business, team and individual objectives with core competences; and (2) *horizontal integration*, linking different aspects of human resource management, especially organizational development, human resource development, and reward, so as to achieve a coherent approach to the management and development of people. Figure 3 below show the role of the accountant and performance management

Figure 3: **ACOUNTANT ROLE ON PERFORMANCE MANAGEMENT**



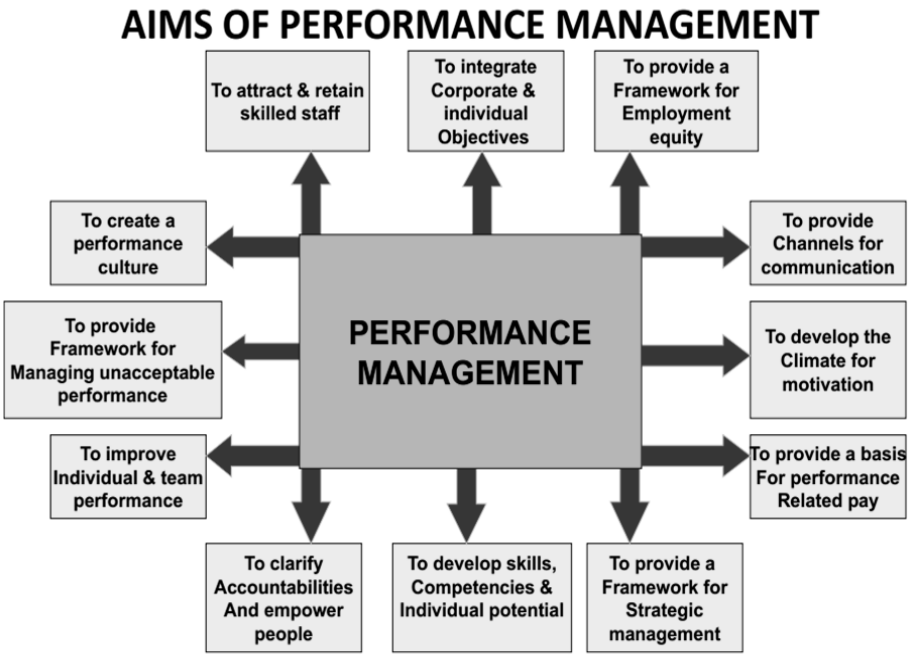
Performance management is, of course, about performance. But what is meant by that word? It is important to clarify what it means, because if performance cannot be defined. It can't be measured or managed. Bates and Holton (2015) have pointed out that performance is a multi-dimensional construct, the measurement of which varies depending on a variety of factors. They also state that it is important to determine whether the measurement objective is to assess performance outcomes or behaviour. There are different views on what performance is. It can be regarded as simply the record of outcomes achieved. On an individual basis, it is a record of a person s accomplishment. Kane (2016) argues that performance is something that the person leaves behind and that exists apart from the purpose. Bernadin, Kane, Ross, Spina, and Johnson (2015) are concerned that performance should be defined as the outcomes of work because they provide the strongest linkage to the strategic goals of the organization, customer satisfaction, and economic contributions.

Performance management should be integrated into the way the performance of the business is managed and it should link with other key processes such as business strategy, employee development, and total quality management. It focuses on future performance planning and improvement rather than on retrospective performance appraisal. It provides the basis for regular and frequent dialogues between managers and individuals about performance and development needs. Performance management is mainly concerned with individual performance and development, but it can also be applied to teams. Figure 4 below show the performance management cycle.



Performance management reviews provide the inputs required to create personal or team development plans and, to many people, performance management is essentially a developmental process. In organizations with performance-related pay, performance ratings are produced to inform pay decisions. There are, however, strong arguments against linking performance management with performance related pay. Figure 5 below show the aims of performance management.

FIGURE 5:



The Overall Aim and Key Benefits of Performance Management:

- Is to establish a culture in which individuals and groups take responsibility for the continuous improvement of business processes and of their own skill and contributions.
- Performance management will aim to instill a customer-service, performance-oriented, transparency and accountability culture within an organisation and align service processes, rules, regulations, and practices with the new culture.
- The key benefits of performance management among others include:
  - Performance management focuses on results, rather than behaviours and activities

- Aligns organizational activities and processes to the goals of the organization
- Cultivates a system-wide, long-term view of the organization.
- Produce meaningful measurements
- Create high performance culture – high performance organization
- Improve organisational efficiency and effectiveness
- Ensure quality services for greater customer satisfaction
- Create costumer service oriented culture
- PMS aligned with vision and mission will provide a clear direction for organization
- Link individual activities to organisational objectives

Conclusion

There have been numerous studies on the transfer pricing problem, especially in the accounting and management literature. In this study, we examine the role of accountant in decentralize transfer pricing and performance management. In a competitive industry, the resulting final price leads to suboptimal overall profit of an individual firm as each markup is successively promulgated down the supply chain. However, all firms in an industry would benefit if they collude on inflating final prices to near-monopoly levels by artificially raising transfer prices.

We demonstrated that the seemingly unprofitable strategy of decentralizing price-setting decisions actually makes sense when considered in a strategic context, incorporating its impact on industry profitability. Transfer prices as the internal price of products created within the company have two main functions profit allocation (in order to assess divisional profits and for performance measurement) and coordination (to come to decisions that are in the best interest of the company as a whole). Various types of transfer pricing exist and are examined in view of these functions in the body of this work; such as market-based, cost-based and negotiation transfer pricing.

Transfer pricing is generally considered the major international taxation issue faced by MNCs today. It is an enormously important issue for many countries, developing and developed, though responses to it will in some respects vary. Transfer pricing is a complex and constantly evolving area and no government of MNC can afford to ignore it.

For both governments and taxpayers, transfer pricing is difficult to grapple with, it tends to involve significant resources often including some of the most skilled human resources and costs of compliance. It is often especially difficult to find comparable, even those where were some adjustment is needed for applying the transfer pricing methods.

For governments, transfer pricing administration is resource intensive and developing countries often do not have easy access to resources to effective administer their transfer pricing regulations. Furthermore, from the government's perspective, transfer pricing manipulation reduces revenue available for country development, and with increasing globalization, the potential loss of revenue may run into billions of dollars. So the accountant must give accurate and proper records/documentations of all activities that took place in his/her center (decentralized).

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