Sampson Electric Limited (SEL)

William Sampson, the president of Sampson Electric Limited, is concerned about the seemingly constant need to mediate disputes between division managers. During 2010, in response to a consultant's report, William had reorganized SEL into three operating divisions with each division manager responsible for the rate of return on divisional assets. The intention behind the reorganization was to free William from operating decisions so he could focus on strategic planning and opportunities for growth. William had been leaning heavily on the division managers to budget and attain the target of 20% before tax return on divisional assets.

The Consumer Division engineers had developed a powerful, general purpose integrated circuit for electronic controls called Supercontrol. As Consumer Division did not have enough production capacity to produce Supercontrols, a contract was made with the Electronics Division to produce Supercontrols for Consumer. The contract called for all Supercontrols manufactured by Electronics to be transferred to Consumer at cost plus 15% regardless of who the ultimate purchaser was. Consumer used Supercontrols in many of its products and also sold them to outside customers, as well as to the Industrial Products Division. In recent years, competitive imitations of Supercontrols reduced external sales to a very small amount. Industrial used Supercontrols in components which it sold to external companies such as electric utilities.

Industrial was, in December 2011, preparing a bid for a large atomic energy contract. The contract would require 500 Supercontrols and Consumer had quoted to Industrial a price of $690 per unit delivered. Industrial’s manager, Alice Murray, obtained from Ace Electronics, a foreign supplier of a device equivalent to the Supercontrol, a quoted price of $350 per unit delivered. Another foreign manufacturer, Brikido Products, was prepared to manufacture a supply of 500 Supercontrols for $400 per unit delivered and would remit a royalty of $100 per unit to Consumer Division in exchange for their blueprints. A transfer pricing problem emerged when Alice Murray advised Syd Smith (Consumer manager) that Industrial would be placing its order with Ace Electronics. Syd Smith was not happy with this decision and immediately protested strongly to the president, William Sampson. In an attempt to defuse the situation, Sampson called a meeting with the managers involved.

William Sampson: “OK – I want each one of you to explain your view on this contract. Let's see if we can sort this mess out and get back to productive activities. You know how I feel about being called into these squabbles! Let's start with Tom.”

Tom Kennedy (Electronics Manager): “Since we started manufacturing Supercontrols for Consumer, it has grown to utilize 40% of our productive capacity. As we now are only at 70% capacity, we cannot afford to have Industrial source these externally." A breakdown of the negotiated transfer price to Consumer for the 500 Supercontrols to be shipped to Industrial for the atomic energy contract is summarized in Exhibit 1.

William Sampson: “OK, Syd, please outline your complaint.”

Syd Smith (Consumer Manager): “There is an understanding that divisions will source internally where possible. The price we quoted of $690 was based on our costs plus a reasonable mark-up. We developed the Supercontrols, and we have to recover our investment. Our sales of Supercontrols are being eroded by foreign competition and, if Industrial outsources from these companies, it will only serve to increase their volume and lead to them being able to quote even lower prices. If we cannot make a fair return, there is no incentive to develop future products!" Consumer's calculations to arrive at their transfer price for the 500 Supercontrols to Industrial are itemized in Exhibit 2.

William Sampson: “Alice, what is your response?”

Alice Murray (Industrial Manager): “The problem I face is that I need this atomic energy contract to fill capacity and make the required 20% return on divisional investment. The Supercontrols are an important element in the bid price and we must shave the bid as closely as possible to get the contract. Here are the supporting data on our proposed bid (Exhibit 3). The problem is that we believe the lowest outside competitor's bid would be about $2,850,000.”

Victoria Goddard (Corporate Controller): “If Industrial sourced Supercontrols from Brikido, it would save $290 per unit ($690-$400) and Consumer would receive a royalty of $100 per unit. Why not consider this compromise?”

Syd Smith (Consumer Manager): “Under no circumstances will we allow the Supercontrol blueprints to be supplied to Brikido. All they want is to access our technology so they can copy it.”

Victoria Goddard (Corporate Controller): “Well, why not allow Industrial to negotiate directly with Electronics and pay Consumer a royalty?”

Syd Smith (Consumer Manager): “The Supercontrol is our product, are we are entitled to make a fair return on it!”

Alice Murray (Industrial Manager): “By the same token, we should be allowed to source from our least costly supplier!”

Victoria Goddard (Corporate Controller): “When the divisions were organized as investment centers, the intent was that transfer prices would be negotiated between the divisions involved. Only in exceptional circumstances were transfer pricing disputes to be referred to the corporate office. Each division's manager is free to make all day to day operating decisions including transfer pricing, as long as the 20% return on divisional investment target is reached based on an approved annual budget.

EXHIBIT 1

Electronics Division price on 500 Supercontrols to the Consumer Division to be supplied to Industrial Division.

Direct materials	$ 60
Direct labour	180
Variable direct overhead	40
Allocated indirect overhead	120
Total Manufacturing costs	***$ 400***
Mark-up per contract with Consumer (15%)	60
Total cost plus mark-up	***$460***
Cost of direct shipping to Industrial	30
Transfer price to Consumer	***$490***

EXHIBIT 2

Consumer Division Quote on 500 Supercontrols to the Industrial Division:

Transfer price from Electronics	$490
Amortization of development costs	90
Processing charge per order	20
Total manufacturing costs	***$600***
Mark-up of 15%	90
Price per unit	***$690***

EXHIBIT 3

Industrial Division cost structure on bid for Atomic Energy contract.

Direct materials *	$1,200,000
Direct labour	950,000
Variable direct overhead	50,000
Allocated indirect overhead	220,000
Total costs	***$4,420,000***
Mark-up (20%)	484,000
Proposed Bid	***$2,904,000***

* Includes 500 Supercontrols at the transfer price of $690 per unit quoted by Consumer Division.