

PLEASE NOTE: This is a rough outline only, intended to help you think through the case.

Exam solutions are expected to be in full sentence and paragraph form.

SAMPSON ELECTRONICS LIMITED (SEL)

ISSUE(S)

MCS is leading to constant disputes between divisions
MCS may be leading to suboptimization
Sampson has to continually intervene

KSF

Free Sampson's time so he can focus on strategic planning & growth
20% ROA
Meeting Budget

BACKGROUND

Company has been in business for some time; appears to be stable
Company produces technical electronic equipment
Innovation appears essential to maintaining market share / growth
Significant erosion of external sales in recent years

CD - Syd Smith - Developed Supercontrols
ED - Tom Kennedy - Manufactures Supercontrols
IPD - Alice Murray - Has an external customer for a product that requires Supercontrols

CD does not have capacity to produce; has 15% contract with ED
ED has 30% surplus capacity

SWOT

Strengths: Innovation / R&D
Weaknesses: Internal disputes, lack of understanding of intercompany pricing
Opportunities: Significant sale to new customer
Threats: competitive imitations of Supercontrol available externally at a lower price

Other relevant points

MCS

Decentralized Structure
3 Investment Centres: 20% ROA required
Budgets

"Should" source internally wherever possible
however, each manager is free to make their own decisions on all business transactions
Transfer prices are negotiated by the divisions

Other relevant points

Evaluation - Qualitative

Managers do not appear to know how to resolve the problems
Don't know what the quality is like for competitors products; could be risking SEL's reputation
Using pricing and mark-up structure indicated, will not win bid for supercontrols.
- Suboptimization will occur
CD may stop developing new products if they cannot sell internally or externally

Other relevant points

Evaluation - Quantitative

At 2,904,000, Sampson will not win this bid; this does not align with KSF of growth.

The competitor's bid is expected to be \$2,850,000. This is only a gap of \$52,500. There are a number of ways to bridge this gap
ACE can provide at \$350
Brikido can provide at \$400 - \$100 royalty fee = \$300; however it is not a good idea to sell the blueprints unless they are sold for a price that will totally cover
CD for their development. Once a competitor has the blueprint, they can use it for any other purposes.
Eliminate allocated and sunk costs from the analysis.
CD deserves some compensation for developing the product, however they do not do any processing, so the \$20 processing fee should be removed

ED could transfer directly to IPD, and IPD could pay a "royalty" to CD.

IPD could pay CD \$100 for each supercontrol provided. This is equal to the royalty Brikido would have paid, so appears to be a "market" price
This would also more than cover the amortization, giving at least a bit of markup
Although less than the other divisions receive, CD also contributes less at this point to this particular contract than the other divisions.

By eliminating all allocated and sunk costs, IPD could lower its bid to \$2,497,200. It does not need to lower it this much to win the bid.
What would be the optimal bid from IPD to the external customer? Let's use 2,800,000 as a suggestion. Would likely be low enough to be 'persuasive'

A surplus of \$302,800 is generated that could be "shared" between the divisions to further motivate and compensate all involved.

We note that 15% is used as the internal transfer price, yet 20% is used for external customers.
This may not be perceived as "fair".

We know the divisions need 20% ROA, however we don't know their asset base so cannot calculate this. We can only assume that if they have previously negotiated 15% mark-up on costs, this must have been enough to provide 20% ROA.

			transfer direct from E to I5	
			Treat Elect as Cost Centive C a \$100 "royalty"	
	Internal	External	Internal	Internal
	Current	ACE	Alt # 1	Alt # 2
Electronics				
Direct Material	60		60	60
Direct Labour	180		180	180
Variable Direct Overhead	40		40	40
Allocated Indirect Overhead	120		-	-
Total Manufacturing Costs	400		280	280
Mark-Up (15%)	60		-	42
	460		280	322
Shipping	30		30	30
Total Manufacturing Costs per unit	490		310	352
Consumer				
Transfer Price from Electronics	490		310	
Amortization of development costs	90			
Processing charge/order	20		20	
Royalty fee charged	-		-	100
Total Manufacturing Costs	600		330	-
Mark-up (15%)	90		50	-
Price per unit	690		380	100
Industrial (change #'s to per unit basis)				
Additional Direct Material	690	350	380	352
Direct Material	1,710	1,710	1,710	1,710
Direct Labour	1,900	1,900	1,900	1,900
Variable Direct Overhead	100	100	100	100
Royalty Fee Paid to Consumer	-	-	-	100
Allocated Indirect Overhead	440	440	-	
Total Manufacturing Costs	4,840	4,500	4,090	4,162
Mark-Up (20%)	968	900	818	832
Total Manufacturing Costs per unit	5,808	5,400	4,907	4,994
Total Manufacturing Costs (for all 500)	2,904,000	2,700,000	2,453,700	2,497,200
Lowest external bid	2,850,000	2,850,000	2,850,000	2,850,000
Difference: This is a very small Variance	(54,000)	150,000	396,300	352,800
Industrial bid price	2,904,000	2,800,000	2,800,000	2,800,000
Total Manufacturing costs (from above)	2,904,000	2,700,000	2,453,700	2,497,200
Additional Profit / (loss) for SEL	-	100,000	346,300	302,800
NOTE: bid at 2,800,000 in order to win the bid				
Under the current situation Industrial will not win the bid because their price is too high, this is why there is currently conflict. The way things are currently, <u>Industrial</u> would be better off to source externally from ACE because then they should be able to win the bid and earn a profit. However this is not the best solution for SEL overall, suboptimization is occurring here. Using full costs as shown will put the bid too high, but only by 54,000. There are MANY ways to resolve this small amount.				
If we look at Alternative #1, this is the true actual cost per circuit and will provide even more of a profit for industrial if the transfer price is calculated properly				
Alternative #2 is another option where Industrial sources directly from Electronic rather than going through the Consumer division and the Consumer division gets paid a royalty fee. The Consumer division may not be happy about this option since they were the ones who developed this product and also they currently have a contract with Electronics. The \$100 "royalty fee" is based on "market value" - the amount Brikido was willing to pay for the royalty fee. This could be considered an objective value.				

There are probably an infinite number of ways to "solve" this transfer pricing issue. All we're really looking for is to shave about \$100 per unit off of the prices somewhere along the line. The problem is, SOMEONE has to be willing to do the shaving. We can't just decide to make a change without considering how that change will impact the manager involved. The MCS is telling each of them that they have to focus on 20% ROA. We need a way to get their eyes off of that and on to the "bigger picture". We're looking for adjustments to the MCS that everyone would feel are fair, and that would motivate everyone to focus on profitable activity, not just their own division's profit.

Recommendations	
The key to an effective MCS is to motivate managers to make the best decisions for overall profitability of the organization	
Managers must feel that any outcomes are "fair"	
Sampson should provide training to the division managers so that they will better understand how to determine transfer prices	
Allocated costs should be ignored when there is surplus capacity.	
CD is mostly involved in development; their asset base may be low. They should be compensated for their efforts, however	
ROA may not be the best structure. Might be more suitable as an expense centre, and evaluated on budgets or standard pricing.	
CD should only develop products that have a viable market, whether internal or external	
Perhaps CD should consider developing and selling blueprints if they can develop products that SEL cannot produce at a reasonable price	
It is best if IPD purchases internally - quality and dependability are assured	
Don't want to risk reputation on "cheap imported imitations"	
Buying from competitors will only help strengthen the competitor's market share and further erode Sampson's	
This type of structure will lead to GROWTH for SEL	
This structure will also free Sampson's time to focus on strategic planning and growth.	