The current pattern is that Division A purchases 3,000 units of product part 101 from Division C (the supplying division) and another 1,000 units from an external supplier. The market price for part 101 is $900 per unit. Division B purchases 1,000 units of part 201 from Division C and another 1,000 units from an external supplier. Note that both divisions A and B purchase the needed supplies from both the internal source and an external source at the same time.

The mangers for Divisions A and B are preparing a new proposal for consideration.

* Division C will continue to produce parts 101 and 201. All of its production will be sold to Divisions A and B. No other customers are likely to found for these products in the short term given that supply is greater than demand in the market.
* Division C will manufacture 2,000 units of part 101 for the Division A and 500 units of part 201 for the Division B.
* Division A will buy 2,000 units of part 101 from Division C and 2,000 units from an external supplier at $900 per unit.
* Division B will buy 500 units of part 201 from Division C and 1,500 units from an external supplier at $1,900 per unit.

**Division C Data 2012 Based on the Current Agreement**

|  |  |  |
| --- | --- | --- |
| Part | 101 | 201 |
| Direct materials | $200 | $300 |
| Direct labor | $200 | $300 |
| Variable overhead | $300 | $600 |
| Transfer price | $1,000 | $2,000 |
| Annual Volume | 3,000 units | 1,000 units |

***Required:***

* Calculate the increase or decrease in profits for the three divisions and the company as a whole (four separate computations) if the agreement is enforced. Explain your thought process, comment on the situation, and make a suggestion based on the computations you have made.
* Evaluate and discuss the implications of the following transfer pricing policies:
  + Transfer price = cost plus a mark-up for the selling division
  + Transfer price = fair market value
  + Transfer price = price negotiated by the managers
* Why is transfer pricing such a significant issue both from a financial and managerial perspective?