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| **The Business Situation** |
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Two years ago, prior to a major capital-budgeting decision (see Case 4), Robert Burns, the president of Greetings Inc., faced a challenging transfer pricing issue. He knew that Greetings store managers had heard about the ABC study (see Case 2) and that they knew a price increase for framed items would soon be on the way. In an effort to dissuade him from increasing the transfer price for framed prints, several store managers e-mailed him with detailed analyses showing how framed-print sales had given stores a strong competitive position and had increased revenues and profits. The store managers mentioned, however, that while they were opposed to an increase in the cost of framed prints, they were looking forward to a price decrease for unframed prints.Management at Wall Décor was very interested in changing the transfer pricing strategy. You had reported to them that setting the transfer price based on the product costs calculated by using traditional overhead allocation measures had been a major contributing factor to its non-optimal performance.Here is a brief recap of what happened during your presentation to Mr. Burns and the Wall Décor managers. Mr. Burns smiled during your presentation and graciously acknowledged your excellent activity-based costing (ABC) study and analysis. He even nodded with approval as you offered the following suggestions.

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| **1.** | Wall Décor should decrease the transfer price for high-volume, simple print items. |
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| **2.** | Wall Décor should increase the transfer price for low-volume, complex framed print items. |
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| **3.** | Your analysis points to a transfer price that maintains the 20% markup over cost. |
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| **4.** | Adoption of these changes will provide Wall Décor with an 11% return on investment (ROI), beating the required 10% expected by Greetings' board of directors. |
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| **5.** | Despite the objections of the store managers, the Greetings stores must accept the price changes. |
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Finishing your presentation, you asked the executive audience, “What questions do you have?” Mr. Burns responded as follows. “Your analysis appears sound. However, it focuses almost exclusively on Wall Décor. It appears to tell us little about how to move forward and benefit the entire company, especially the Greetings retail stores. Let me explain.I am concerned about how individual store customers will react to the price changes, assuming the price increase of framed-print items is passed along to the customer. Store managers will welcome a decrease in the transfer price of unframed prints. They have complained about the high cost of prints from the beginning. With a decrease in print cost, store managers will be able to compete against mall stores for print items at a competitive selling price. In addition, the increase in store traffic for prints should increase the sales revenue for related items, such as cards, wrapping paper, and more. These are all low-margin items, but with increased sales volume of prints and related products, revenues and profits should grow for each store.Furthermore, store managers will be upset with the increase in the cost of framed prints. Framed prints have generated substantial revenues and profits for the stores. Increasing the cost of framed prints to the stores could create one of three problems: First, a store manager may elect to keep the selling price of framed-print items the same. The results of this would be no change in revenues, but profits would decline because of the increase in cost of framed prints.Second, a store manager may elect to increase the selling price of the framed prints to offset the cost increase. In this case, sales of framed prints would surely decline and so would revenues and profits. In addition, stores would likely see a decline in related sales of other expensive, high-quality, high-margin items. This is because sales data indicate that customers who purchase high-quality, high-price framed prints also purchase high-quality, high-margin items such as watches, jewelry, and cosmetics.Third, a store manager may elect to search the outside market for framed prints.”Mr. Burns offered you the challenge of helping him bring change to the company's transfer prices so that both business units, Greetings stores and Wall Décor, win. From his explanation, you could see and appreciate that setting the transfer price for unframed and framed prints impacts sale revenues and profits for related items and for the company overall. You immediately recognized the error in your presentation by simply providing a solution for Wall Décor alone.You drove home that night thinking about the challenge. You recognized the need and importance of anticipating the reaction of Greetings store customers to changes in the prices of unframed and framed prints. The next day, the marketing team provided you with the following average data.

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| **·** | For every unframed print sold (assume one print per customer), that customer purchases related products resulting in $4 of additional profit. |
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| **·** | For every framed print sold (assume one print per customer), that customer purchases related products resulting in $8 of additional profit. |
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| **·** | Each Greetings store sets its own selling price for unframed and framed prints. Store managers need this type of flexibility to be responsive to competitive pressures. On average the pricing for stores is as follows: unframed prints $21, steel-framed without matting $50, wood-framed with matting $70. |
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|  | **Exercises** |
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| **Instructions*****Answer each of the following questions.*** |
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| **1** | Prepare for class discussion what you think were the critical challenges for Mr. Burns. Recognize that Wall Décor is a profit center and each Greetings store is a profit center. |
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| **2** | After lengthy and sometimes heated negotiations between Wall Décor and the store managers, a new transfer price was determined that calls for the stores and Wall Décor to split the profits on unframed prints 30/70 (30% to the store, 70% to Wall Décor) and the profits on framed prints 50/50. The following additional terms were also agreed to:

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| **·** | “Profits” are defined as the store selling price less the ABC cost. |
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| **·** | Stores do not share the profits from related products with Wall Décor. |
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| **·** | Wall Décor will not seek to sell unframed and framed print items through anyone other than Greetings. |
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| **·** | Wall Décor will work to decrease costs. |
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| **·** | Greetings stores will not seek suppliers of prints other than Wall Décor. |
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| **·** | Stores will keep the selling price of framed prints as it was before the change in transfer price. On average, stores will decrease the selling price of unframed prints to $20, with an expected increase in volume to 100,000 prints. |
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Analyze how Wall Décor and the stores benefited from this new agreement. In your analysis, first **(a)** compute the profits of the stores and Wall Décor using traditional amounts related to pricing, cost, and a 20% mark-up on Wall Décor costs. Next, **(b)** compute the profits of the stores and Wall Décor using the ABC cost and negotiated transfer price approach. Finally, **(c)** explain your findings, linking the overall profits for stores and Wall Décor.The following data apply to this analysis. (Round all calculations to three decimal places.)

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|   | **Unframed print** | **Steel-framed, no matting** | **Wood-framed, with matting** |
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| Average selling price by stores before transfer pricing study | $21    | $50    | $70    |
| Average selling price by stores after transfer pricing study | $20    | $50    | $70    |
| Volume at traditional selling price | 80,000    | 15,000    | 7,000    |
| Volume at new selling price | 100,000    | 15,000    | 7,000    |
| Wall Décor cost (traditional) | $17.36    | $33.48    | $48.10    |
| ABC cost | $15.258    | $39.028    | $55.328    |

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| **3** | Review the additional terms of the agreement listed in instruction 2, above. In each case, state whether the item is appropriate, unnecessary, ineffective, or potentially harmful to the overall company. |
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