Inter-trading

A brief description of the business model

Collinson Grant

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Introduction

Collinson Grant has helped businesses - in the United Kingdom, in continental Europe, and in the United States - to change the character and effectiveness of their business models. This responds to changes in markets, technology, the supply chain, cost and competitive pressures generally. In this book we describe our experience of business models in which profit centre business units, subordinate to a common parent organisation, inter-trade goods and services.

When this happens, the managers in the subordinate businesses and in the common parent may have to answer such questions as:

- How should the inter-trading prices and terms be set?
- How would that affect profit and loss reporting, and how would the financial returns of each inter-trading business be measured objectively?
- What principles should be adopted and transactional methods used to report inter-trading business?
- How can commercial and planning disputes between inter-traders be avoided?
- What information systems and support for decisions are needed to understand and control inter-trading transactions?
- What are the best models and configurations to maximise the common owner's profit?

This book stresses the importance of choosing a model to support a trading strategy rather than allowing inter-trading to develop by custom and practice, distorting profit.

The business model

Inter-trading becomes necessary when the value chain of a company's products or services passes through two or more of its subordinate units, both accountable for profit and loss. This makes the profit centres into buyers and sellers of partly finished goods within an enclosed system of exchange or value chain. Despite being locked together in common ownership, each needs to price and pay for goods and services within conventional systems of accounting, so that each can make margin on the transaction and report profit. So, how to do it?

Take a simple example. An oil company has four subsidiaries: to conduct exploration; to pump oil from its wells; to refine the product; and to market the oil. All have accountability for their own profit and loss. Each business has to quantify the increments in value that occur inside the profit centre as products move through successive stages of the parent organisation's chain of value. The results they report will depend in some degree on how the terms for inter-trading are designed, essentially the price of the trade.

Inter-trading prices are used to assign value to the product as the first business trades with the second (and in a long chain such as oil) the second with the third and so on. In a fully managed system of inter-trading, these prices would be fixed by a method determined or approved by the parent company. For reasons that will become clear, it is barely an option for the prices to default to a free market price as would be the case between unrelated willing buyers and sellers not under common ownership.

Defining characteristics

Business models that rely on inter-trading can be qualified in four ways.

- Transactions take place between sibling organisations under the authority of a single parent or common owner
- The parent organisation is minded to oblige the subsidiary businesses to sell some or all of their goods and services to each other –it mandates the inter-trade
- The sibling organisations add value to the products or services traded between them, causing them to share the same value chain
- The sibling organisations are accountable for, and report through, their own, separate, profit and loss statements – they are discrete profit centres.

Normally all four conditions are present when businesses inter-trade.

Transfer price and value

In conventional capitalism, resources are allocated in response to supply and demand, and to cost and price. Prices tend to find their own level when they are struck: when willing buyers and willing sellers act on the relative strengths of supply and demand. This is so fundamental to industry and commerce as we know it that it is easy to forget that other options for setting prices may be needed in some circumstances.

In an inter-trading regime, the business model dictates that value will be a function of policy, not of free market economics. Though it cannot be based on subjective need, inter-trading is nevertheless a process that requires regulation and intervention. Units bound together by common ownership and a common value chain cannot create price as the free market does.

In these circumstances, the utmost care is needed to obtain a true and fair view of the reality behind how incremental value is measured and added into profit.

Value chain

The concept of the value chain helps to point up the stages through which goods or services pass as value is added by each profit centre in the chain. Each value chain has a unique configuration shaped by the processes and the positions they hold in the sequence of links. Value chains vary in length (number of business units in the chain) and size (value added) of the links.

Value chains may be deliberately designed or simply evolve. It is best if an evolved configuration and methodology for valuing outputs are replaced by a design that fairly and logically determines where profit and margin should be taken.

Reporting the business

Although financial accountants have various ways of dealing with inter-trading book-keeping, the information of interest to managers is what supports such decisions as (in the example of the oil company)

- How profitable is drilling?
- What are refining margins?
- What is the return on capital employed in marketing end-products through retail filling stations?

The answers are valuable, not because they will be right or wrong, but because they will, potentially, inform logical, profit-seeking decisions on investment, cost control, volumes and so on.

In addition, decision-supporting information must help the company:

- to retain control over its business model, particularly when inter-trading assumes some complexity, and there is danger of lost transparency
- to set transfer prices so that it can take profit in the amount and at the point in the value chain that best serve the company's interests
- to promote efficiency and effectiveness in managing the processes in all the company's inter-trading business units

Inter-trading may be at the heart of a business model or peripheral to it. Which of these depends on how much of its revenue or cost is represented by the value of inter-trading transfers. Anything above, say, 5% could materially influence the reported financial results of the inter-trading parties. So about this point there begins to be a need for a considered policy on inter-trading, and a regular system that reports and accounts for inter-trading transactions. Of these, the most important is the inter-trading price itself.

Inter-trading pricing

The necessity to regulate

The common parent of inter-trading businesses must exercise authority to fix the method by which the inter-trading price is set: its sibling business units are impotent to do so. The business model that binds them into mutual trade removes their option to negotiate and agree on a market price that reflects the strengths of their respective positions. And because the goods and services that they are directed to trade are in the same value chain, the suppler is obliged to plan capacity and to offer uninterrupted supply of a quantity exactly equal to the user's expressed demand.

This business model has the effect of imprisoning both parties in artificially weak positions because they are prevented from negotiating freely or to any real purpose. Neither is owner of the business model. Each party's cards are known to the other in a way not usual in conventional, third-party deals.

It may be that an inter-trading price that would suit both parties, and that recognises some mutual 'goodwill', might resolve the problem of setting an agreed price. However, that could not be relied on. Goodwill can be in short supply, in 'corporate families' as in others. It is known that sibling organisations, abandoned by the common owner, to 'slog it out' through bullying or bluff and counter bluff, have sometimes resorted to expensive internecine strife; or to cartel-type agreements to cover up inefficiencies that act against the interest of their common owner.

More importantly, a transfer price that suited both parties might not report profit in the way that suited the other important party, the common owner of both businesses. It is important that this parent of both understand and correctly record the wealth creation taking place in the value chain under its ownership: how its wealth is created; where its profits come from; and how effective its business model is.

Mechanics of price

There are a number of ways for the owner of the business to set inter-trading prices. But to set them with confidence, it is even more necessary than usual to know the costs. A known relationship with cost supports the decisions managers will have to make. For example, is the inter-trading price to be more than, the same as, or less than the understood cost? And if more than cost, by how much more?

Usually costs are researched from internal data in order to test the margin available at a given price. This will be followed by a series of commercial judgements and financial plans, after which sales and marketing activity can take place. A lot will depend on whether the same or similar goods are inter-traded and sold in the open market concurrently.

Many inter-trading prices are set to a cost plus formula of a type common in the public sector, or in the private sector when a contract is expected to run for a similarly long and uncertain period. An example might be a ground-works contractor in a construction group which is sibling to the design and build business in the same group. In other cases cost plus means, say, £1 each plus 15% to give a 15% return on sales, or £1 each plus 20p to yield 15% return on capital employed, calculated from the company budget.

The policy applied to setting inter-trading prices might properly be influenced by the lower commercial risk that is associated with inter-trading. Conventional calculations of return assume that high risk of the loss of capital, or of an under-utilisation of capacity because of unstable demand, merit an aspiration to commensurately high returns. Inter-trade is not exposed on these fronts.

Pricing policies

Banking profit early in the value chain

If the value chain of an organisation extends through several subsidiaries before output is eventually sold to an external customer, the owner of the business model is able to choose to turn cost into profit and loss by adding most margin in the one or more profit centres that come early in the succession. Margins and profit in the first profit centre are then fatter than those budgeted or realised from the second or from others further down the chain.

Adding margin early defines the business model. It is justified as an effective means of squeezing the last drop of profit out of increasingly challenging inter-trading prices on subsequent trades, particularly at the last one to a third-party customer. These low inter-trading prices and relatively high targets for margin and profit can be the instrument for forcing cost out.

Sometimes the strategy is articulated in the claim that it 'prevents sales teams from giving away margins' to the external customers. That is to say, when salesmen have no margin to give away, they cannot be seduced by customers into agreeing to low tariffs or spot prices, 'low ball tenders', or other stratagems to shift volume or rescue total revenue targets in hard markets.

In extreme cases, any potential margin from the open market may already have been exhausted before the last amount of value has been added. The problem that this may present is that the margin to the external customer becomes harder to know, and the customer's motivation for buying harder to interpret. This is particularly so if the value chain is long and the relationship between sibling parties at the high and low ends of the chain is remote. The control over the profitability of products may not be centred in a recognisable place. Furthermore the sales personnel and profit-responsible managers who are selling to 'real' customers may become demoralised when little or no profit can be made and attributed to them. This can adversely affect the sales and marking effort.

Another concern is that the high margin yields won early in the passage of the product down the value chain may lead to complacency in managers there, disguising inefficiencies which, if they could be seen for what they are and tackled, would create higher profits for the parent.

Taking margin at the external point of sale

The opposite strategy is also commonplace. Little (sometimes no) margin is embedded in inter-trading prices. All or most is reserved for the final, external sale. The logic of this is that the only real margin is that realised from prices in a free and open market. To know and report this, and to base all analysis of the profitability of products on it, is to achieve the truest measure of profitability.

There can then be a focus on getting the maximum sales effort in one place. To avoid the 'low balling' problem, it is usual to apply controls on the sales prices, if necessary to a design approved by the owner of the business model, and possibly even under its direct authority.

It is common for companies to suffer systemic bidding failure if sibling businesses need to collaborate to win bids. Each business often blames the other for destroying competitiveness, usually with allegations of greed aimed at those early in the chain. This problem is usually solved by instituting a 'group' procedure for approving tenders in which there is an oversight at the level of group (parent organisation) of any bid price or tariff to which two or more profit centre business units are contributing.

Equitable returns

As value is inter-traded between the businesses they own, some parent companies consider that each subsidiary that adds value should be allowed to earn a fair return on the capital used or the revenue generated. The return that is then targeted is a calculation reflected in the approved inter-trading prices.

There are always as many views about what is a fair return as there are parties with an interest in it, even after any agreement on the best type of return to be targeted, whether it be on sales, capital employed, net assets or fixed cost.

And there are further challenges to be faced when, for example, a 'fair' figure of, say 5% on sales, is thought to be a fair average but it is felt 'more fair' - or more challenging - for some of the relevant business units than for others. The technology, innovation, or quality required might not necessarily be paralleled by the costs of production. Some business units in the chain may think it more just that some be asked to add value at 5% ROS but others at, say, 10%. All such judgements can feel subjective.

This problem is compounded if reasonable returns are agreed on but the sibling organisation that sells to the external customer is having trouble hitting its target return because the market has stopped paying the prices necessary for it to do that. In that scenario those merely inter-trading win out even though they may have the most scope for reducing costs. The sibling business which is the final adder of value and has the vital task of selling is over-exposed to failure. This is not a recipe for harmony up and down the value chain.

If the value chain is short, a fast and flexible response to external market problems may be possible. If the value chain is long, that may, because of the number of links in it, be more difficult. The difficulty may be affected by the extent to which players in the value chain have an investment in it. Is the product line central to their sales effort or merely peripheral? If they have large external markets for the partly processed product, or for unrelated products, transfer prices are less crucial to financial outcomes and easier to set without fuss. The natural arbiter in all this still remains the parent organisation.

What should be avoided is an arbitrary agreement for a percentage return – a sort of 'ex gratia gift of margin or profit'. In a case in point, a manufacturer used a sibling organisation as a depot for low-cost stocking before onward transit to a third sibling for final manufacture and external sale. In an informal arrangement, the depot service was 'awarded' a nominal 5% of the value of goods crossing its threshold, thereby ill-advisedly distorting the measurement of relationships between costs and revenue.

Synthetic market valuation

It is not unusual for a proportion of the production of a product to be sold in the open market while some of it is transferred downstream to a sibling business for further processing before sale. In such cases the open market price provides a sound basis for setting the inter-trading price.

Even if the inter-trading sibling company does not sell externally, it may still be possible to research price equivalents when there is a third party organisation that does. The inter-trading value can then be synthesised from market research.

The problem with this attractive option is that open market prices may vary with location, product, customer, rebates earned, or otherwise. Nevertheless a realistic price can often be synthesised. Data are simply projected or extrapolated (incorporating 'what ifs' and 'if onlys') to arrive at convincing inter-trading prices.

International inter-trade pricing

As we have seen, inter-trading takes place exclusively between separate business units that are accountable for profit and loss where they exist within a single parent company or group. But these parts of the group, though linked by the same value chain, may be located in more than one country. In one respect, the management accounting for profit and loss in each domain can just ignore this. The effect of currency movements can, of course, be shown as a variance. Exposure can be excluded from or included in the inter-trading price according to the use to which information on, say, margin is to be put. Thus, the system of accounting for profit in the one place or the other in order to measure added value consistently can be entrusted entirely to the Finance department.

A greater challenge, however, may be the need to employ different transfer prices to fix profit in each country by a method, or at an amount, that satisfies different tax regimes. Some tax authorities are said to be suspicious of any parallel transfer prices used for management information or cost accounting. They may spot that these, were they applied to tax, would improve its yield. So it may be prudent to keep transfer prices that are primarily used as internal measures and controls over performance well away from the official audit trail.

Terms of trading

Terms

Formal terms of trading such as credit given or taken, conditions of sale, warranty and so forth are sometimes necessary, sometimes not. Sibling companies may comply with a consistently applied group practice in these matters or may not. They may be self-accounting or served by a shared service centre. The inter-trading parties may not only be separate profit and loss accounting centres but have separate banking arrangements and their own KPIs and budgets controlling cash flow. Terms of trading will therefore cover transactions for which invoices will be rendered against terms for credit given and taken, perhaps even with penalties for non-compliance with the agreement or contract.

Terms of trading also need to have provision for how transfer prices can be changed and, particularly, how and when adjustment may be made for cost inflation, such as in the cost of commodities. Getting a price increase (or resisting it) in a transfer pricing relationship can be one of the more frustrating and time-consuming tasks undertaken by a business executive. None of this matters too much, provided that there are rules in place for behaviour and process.

Restitution and compensation

When things go wrong, for example if inter-traded goods or services are alleged to be unsatisfactory, it is usual to have ready a code of practice that determines the provision for restitution, if any. It is important to have put in place a very robust process to handle this well before it is actually needed. As with the inter-trading price itself, buyers and sellers are bound together by the ultimate owner of the business to whom both belong.

Neither can walk away, even though the dissatisfaction might in other circumstances make this a natural course of action. With inter-trading, agreement on restitution in the wake of a complaint can be especially difficult to reach, while recourse to law is impracticable and unlikely, even though this has been known to happen when the parent has been weak and a policy vacuum has existed.

A longer list of things that can go wrong, and for which some prior agreement on corrective action or compensation may be needed, includes:

- providing sub-standard quality, or failing to meet specification, with alleged associated costs of returning or disposing of the goods
- poor performance on delivery, possibly leading to consequential loss of performance in downstream processes, including the costs of the overtime required to make up for the delays and the costs of the penalties imposed by external customers
- unscheduled deliveries causing unplanned stocking, with the associated costs, which may include writing off the value of work-in-progress
- costs associated with cancelled orders, for whatever reason or cause attributed.

There may be other problems to be covered that are specific to the inter-trading context. These need to be anticipated before actual conflict arises, bearing in mind that settling these or any problems between inter-trading parties is more difficult than in conventional customer/supplier relationships.

Hazards of this sort are present in all inter-trading arrangements. The parent company ought to devise, or agree and authorise, some principles that provide a consistent line in restitution. It might be that the answer to some problems is not to be found in restitution at all. Not all parent organisations would, for example, wish time and money to be used pursuing disputes, and sending money backwards as well as forwards down the value chain. For example, inter-trading suppliers' performance can be monitored, and action taken by the parent to resolve cases of under-performance through managerial rather than financial solutions.

Book-keeping and accounting

Subsidiary company and divisional accounts usually include inter-trading revenues and costs as an essential part of the published management accounts. Consolidated Group accounts, however, will invariably treat inter-trading revenue transactions as eliminations, avoiding double-counting their income.

Strategy and structure

Structure

In a business with a conventional, unitary organisational structure, all value-adding activity, by definition, takes place within the single profit centre for which its chief executive and managerial team take responsibility. There is, of course, a value chain, but it will pass through the departmental and functional areas that make up the structure. Such a model offers no inter-trading challenges.

But that structure, a single profit centre, can be changed - and not necessarily by creating incorporated subsidiaries. Profit centres can be created notwithstanding and might be justified on grounds that they make it easier to measure managers' performance and accountabilities, and to exercise control. Each profit centre created may be a self-contained, independently managed division of the larger business. This may enable the parent company

- to place a limit on managerial spans or unit size
- to distinguish particular activities or skills in order to sharpen focus
- to recognise the effects of location, site, sunk and new investment, and so on.

The Centre, the common owner or parent, will have particular regard for the importance of attributing profit *to*, controlling the cost *of*, and pursuing sales *from* the devolved platform it has created. Whether its devolved units are incorporated operating subsidiaries or not, they become inter-trading siblings and subject therefore to the need to comply with some system or rules on price, terms, behaviour and so on.

Synergy

Entities created by devolving a business into profit centres may seek the benefits of synergy in adding more value together than would be possible for each alone. This possibility may be discovered by serendipity, or may be deliberately conceived at the corporate centre. In this context the synergy is almost always associated with an over-riding objective owned by the group parent or common owner rather than by the individual inter-trading units.

The oil company is a good example of this. Its vertically integrated configuration is its main competitive advantage over organisations that have more fragmented or looser structures. The synergy that comes with inter-trading helps to exploit to maximum effect the profit to be made from the scarce raw material. Keeping control of every point along the value chain maximises the profit to be wrung out of ownership. Only inter-trading can achieve this. Furthermore, this business model creates barriers to market entry by competitors.

The use of a vertically integrated model, with multiple business units strung along the value chain, does not prevent those units from trading their outputs with third parties. A vital decision for those managing the whole organisation is how much to release into the market at each intermediate point and how much to retain until the process at the end of the chain - retail sales - is complete.

As we know, large quantities of crude oil end up as petrochemical products because supply and demand and pricing are used to optimise profit. Making sales at multiple points along the chain generates cash flow for the investment that sustains the chain. This decision also faces the company discussed in the next section.

Reviewing the value chain

It is just as important to analyse and understand the inter-trading data of a business as its conventional external transactions. However, this is often ignored. A tendency exists to assume that inter-trading and intra-Group sales are a lower 'grade' of sale for which the only reporting necessity is a figure needed for group eliminations. But more analysis is safer. The impact of the inter-trading configuration on the business model ought to be clear and the value chain mapped and fully understood.

In the real example shown below the parent company operates six incorporated manufacturing profit centres, (DON, WQ, BAC, SSS, BTS and PTB). Each one is based on different processes, operating for historic reasons on different sites. Each reports to the parent through its own profit and loss account. All the businesses make external sales as well as inter-trading with peer profit centres supplying downstream processes. The profit centres also inter-trade with three other home and overseas divisions engaged in distribution (CUK, CFE and BNZ).

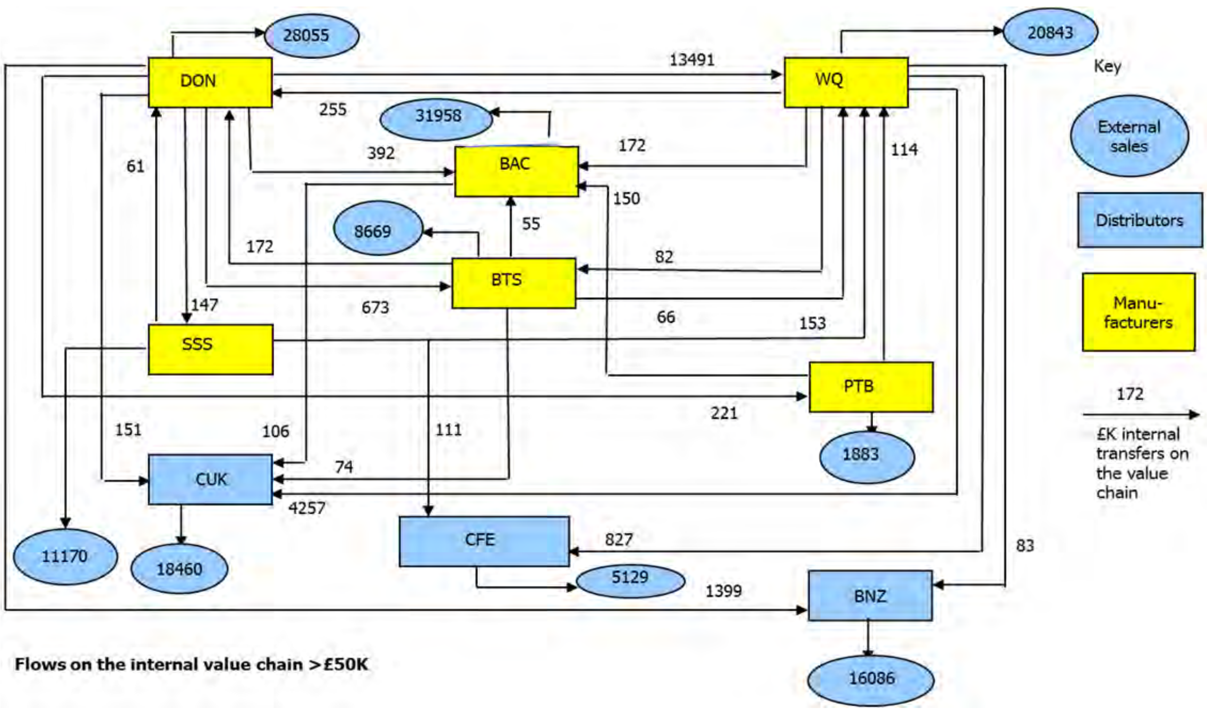
The data on sales, margin and margin percentage in the following three tables were collected by special analysis from the accounting record. The data in the first table were used to create the value chain map shown overleaf.

Sales inter-trade value							
£K	S&J Group inter-trade sales (extract only)					External	Inter-
Sales by/to	DON	SSS	PTB	WQ	CUK	sales total	trade %
DON		147	221	13491	151	28055	33
SSS	61			153		11170	1
PTB				114	106	31958	10
WQ	255				4,257	20843	18
CUK						18460	

Margin inter-trade value						
£K	S&J Group inter-trade margins					External
Sales by/to	DON	SSS	PTB	WQ	CUK	margin total
DON		59	99	6476	38	15150
SSS	37			77		3798
PTB				89	58	17577
WQ	122				1831	14590
CUK						4615

Margin inter-trade %							
%	S&J Group inter-trade margin %					External %	Inter-
Sales by/to	DON	SSS	PTB	WQ	CUK	margin average	trade % average
DON		40	45	48	25	54	48
SSS	61			50		34	53
PTB				78	55	55	67
WQ	48				43	70	46
CUK						25	

The map shows a value chain of twenty-three inter-trading flows between the nine profit centres. In some flows, such as DON and WQ, inter-trading transactions take place in both directions, making a complex picture, imperfectly understood by managers.



Flows on the internal value chain >£50K

Equivalent maps were also drawn for margin and margin percentage. Others can be drawn for different product types, and for volume and added value.

The data in the third table show margin percentages achieved by the sellers on peer-to-peer inter-trading, and the weighted average margin percentages for all the inter-trades. No consistent pattern of margin percentage can be discerned in the inter-trades. So the coherent regime for pricing that one would have hoped for is lacking.

The conclusion to be drawn is that the profit centres inter-trade without the strategic direction from the centre that would give a defining characteristic to the business model. The profit and loss accounts of the divisions lack some meaning because the inter-trading revenue is calculated from unstructured prices, yielding percentage margins from which no business information or standard for control may usefully be derived.

The full consequences of such an absence of analysis, and loss of control, can result in misinformation on a wider canvas. First there is the apparent inability to understand the significance of profit and loss and its elements - cost, margin, and average selling price.

Secondly, it is not clear how the internal value chain can best be configured and optimised: or, therefore, how the company's business model should best function to promote its efficiency and effectiveness. For example, just some of the questions that could be asked are:

- Are all the subsidiary profit centres necessary?
- Is there a case for rationalising the managerial structure, and the scope and scale of accountability for profit?
- Need all the existing business units report profit and loss?
- Could some processes be contracted out to add more value?

It is common for the flows of inter-trading not to be understood by senior managers for whom the properties and health of the business model should be the primary concern. For there to be managerial control over a business, inter-trading data need to be reported for:

- Inter-trading sales
- Margin and margin per cent on inter-traded sales
- Volumes of sales
- Average selling prices (ASPs)
- All the above broken down, if necessary, by product or process
- Comparison between inter-trading data and the equivalent for external sales

Contracting out

A parent organisation that is in control of its business model, the configuration of its value chain, and its inter-trading terms is in a position to consider whether it could with advantage contract out any processes of its business units. In this way it might be able to control the value chain and the inter-trading pricing structures without having to own all the assets employed.

The oil industry again provides an example. In fact, oil companies often contract out major processes such as drilling. Of course, for contracts to work properly, it is essential that the inter-trading prices should add value and that risk should be taken fully into account.

In extreme cases of contracting out, inter-trading offers examples of virtual models in which the owner of the business model will itself own very few of the assets employed in the value chain. Despite this, it may be able to retain control over the configuration of the value chain and the inter-trading prices charged, and to seize the lion's share of profit.

In a real example, a company requiring shipping containers for its leasing business contracted out their manufacture. It exercised control over the whole manufacturing chain of value by negotiating the inter-trading prices for the raw materials and the value added by the first and second-tier suppliers with the final builder. The option to put all its effort into negotiating the lowest possible purchase price of fully built containers was replaced by a series of separate contracts with each supplier in the chain. Each contract set an inter-trading price a part of which was remitted directly to it as the owner of business model. It thus banked margin at each stage as the product moved down the value chain as well as from the final process of leasing, which it operated through processes and resources wholly its own.

A particularly complex example of such a virtual value chain owned by a single owner in control of the business model is to be found in the insurance industry. An insurance company may own the model through which it conducts its business while sharing the value chain with other participants with whom it contracts. Thus an insured customer buys a policy from a sales and marketing agent such as a bank or a broker for whom the commission is a negotiated inter-trade price at the front end of the value chain. The underwriter's fee is another inter-trade price. In the event of a claim, the claims handler and (if appropriate) the specialist medical or other service provider also provide processes and are remunerated through further inter-trade prices pre-arranged with the insurance company.

The whole value chain is owned and commercially orchestrated by the insurance company, whose business model determines and controls the operational relationships of all parties. The inter-trading prices all along the complex value chain are devised and owned by the company to which all other players are symbiotically linked. At one time insurance companies themselves performed these processes on what then was a wholly internal value chain in a single profit centre model. Now, although contracting out these processes, they continue to own the network of what are in effect a series of virtual inter-trades off a tariff that remains their own.

Transfer pricing at cost

Of the various policies available to those designing inter-trading models, one that gives the firmest and most exemplary control over margins and costs uses a cost-based standard for inter-trading between business units. While not suitable for all business models (it would not be used by the oil company, for example) it effectively turns profit centres into either production cost centres or external sales margin centres. The model then requires the production business units to break even, and the sales margin units to maximise the margin earned from their sales to third parties.

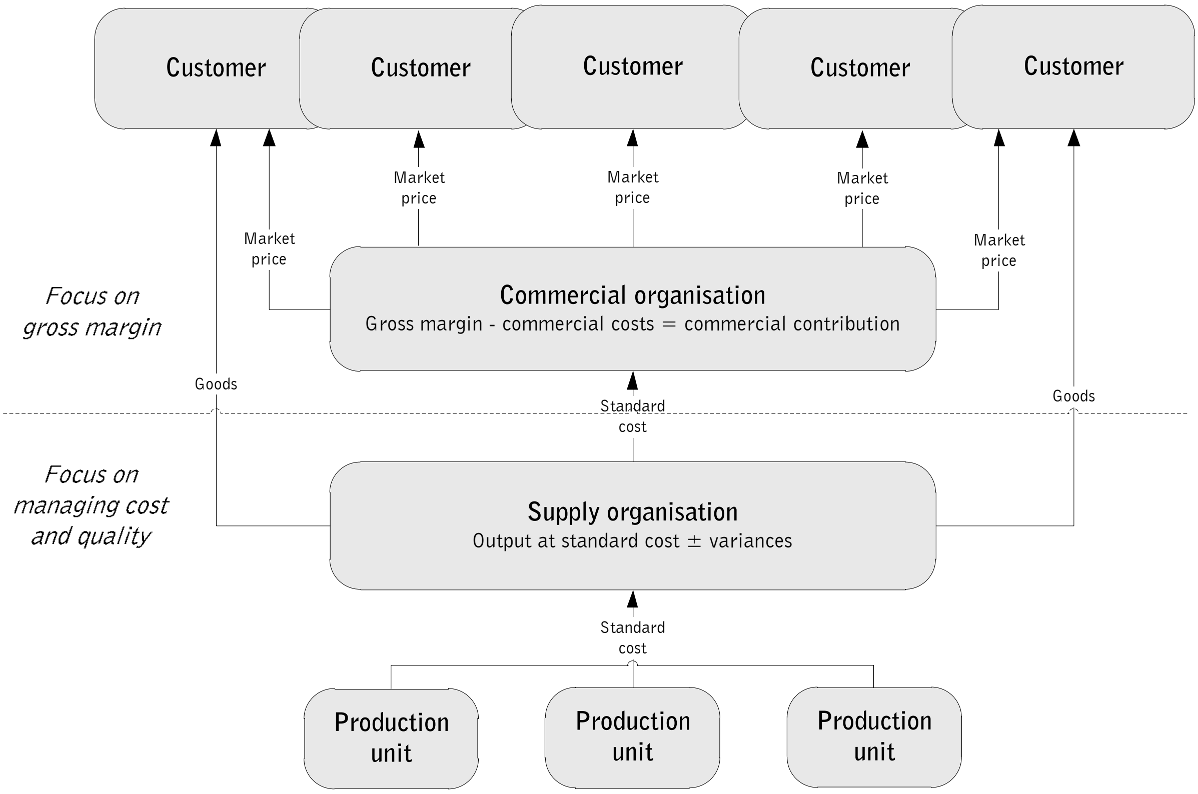
This model configures the value chain so that production process centres pass partly finished products between them at a transfer cost price, no margin being taken. Finished products are passed, again at cost, to one or more trading business units. When products are sold at market price, the whole margin is taken and put into the company's profit and loss after the costs of sales and marketing have been charged.

The result is that the centres of production record surpluses or deficits depending on whether the inter-traded (transfer) value created and 'sold' on at cost is greater or less than the actual expenditure incurred in production. The surplus or deficit is posted to the profit and loss account of the whole business model.

The gross margins on sales of finished products (revenue less inter-trade transfer value 'paid') are charged with the related costs of selling. The net margin can be posted to profit and loss.

In this system the accountabilities for producing at standard cost, and for selling at the required margin, could hardly be clearer. Control is firm. Information on managerial performance and financial results is transparent and largely without ambiguity as the chart below illustrates.

Instead of the complex configuration of inter-trades between many profit centre business units, these can be consolidated into a simpler structure. This changes the meaning of inter-trading by rationalising to a known cost the basis of charging along the whole length of a complex value chain. It improves accountability and control, and makes for easier and more transparent reporting. Importantly, it removes the difficult challenge of finding a logical way of determining inter-trading prices.



Behind the model is the principle that business units with production processes should be managed with accountability for optimising unit cost, with no expectation of generating margin out of manufacturing processes.

Similarly, sales and marketing units should be accountable for achieving selling prices that generate the best possible margin percentages. And margin does not move around if costs change because the effect is confined to the production unit.

It is usual to operate this business model with a system of price controls, because, although the whole margin is the property of sales managers, their exposure to the results is easily and unambiguously measured. Transfer pricing at cost offers more control over accountability and performance than any other model of inter-trading.

Collinson Grant

Costs **People** **Organisation**

Productivity **Performance** **Restructuring**

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Complexity, Direct costs, Employee relations,

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