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Goliath Corporation: An instructional case in transfer pricing policy

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Abstract

This case illustrates some of the issues associated with setting firms' transfer pricing policies. The simulation requires students to assume the roles of top management and divisional management for Goliath Corporation in negotiating transfer prices. The student playing the role of top management first selects a transfer pricing policy from four possible mechanisms: *market-based*, *cost-based*, *negotiated*, and *dual-pricing*. Given the top manager's policy choice, divisional managers are then constrained to use that policy as they decide whether to purchase internally or externally based on their respective negotiations. In each negotiation, there is an ex ante best decision for Goliath as a whole. The case is thus useful in demonstrating how managers' transfer price policy choices can lead to bad sourcing decisions.

Keywords: Transfer pricing; Goal congruence; Experiential learning

1. Introduction and synopsis

This paper presents an instructional case that is useful in illustrating the issues associated with setting firms' transfer pricing policies. The case requires students to assume the roles of top management and divisional management in negotiating transfer prices. The organiza-

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tional dynamic is modeled around the chief executive officer (CEO) of Goliath Corporation and the autonomous managers of the Plastic Products, the Metal Products and the Electronics Divisions of Goliath. The simulation requires first that the student playing the role of CEO choose a transfer pricing policy from four possible mechanisms: *market-based*, *cost-based*, *negotiated*, and *dual-pricing*. After the CEO makes the policy decision, which binds the divisional managers to the use of that policy, the divisional managers then face insourcing/outsourcing scenarios and are required to decide whether to purchase internally or externally based on the respective policy choices. Given that there is an ex ante best decision for Goliath Corporation as a whole in each negotiation, the case is useful in illustrating how policy choice can lead to good or bad insourcing/outsourcing decisions. We conclude by discussing some of the insights that should be possible from the exercise.

The case also highlights an organizational design issue that is increasingly important given the rapid integration of both information technology and globalization in the modern business environment. Interconnections within and between potential customers and suppliers, both internal and external to the firm, will increasingly impact students in their subsequent careers. Thus, an improved understanding of the challenges faced by decentralized organizations in motivating and measuring performance will help satisfy the demands of both potential employers and business school graduates for relevant classroom content. Finally, we find that the case makes the teaching of transfer pricing policy and outcomes, a subject that is often relegated to appendices in textbooks and greeted with little enthusiasm by students, a more engaging subject for instruction and discussion. Our experience has been that students enthusiastically participate in the group exercise and appreciate the positions of the other students in the group. While our recent experience has primarily been focused on graduate students as participants, the case translates well (with appropriate class preparation) to upper-division undergraduate accounting and finance students.

The remainder of the case is structured as follows. In the following two sections, we present the case procedures and materials used to administer the group exercise. In the fourth section, we present the solutions to the case as they pertain to the "best decisions" for Goliath Corporation given the case materials. Finally, we present some of our insights into students' reactions to the case.

2. Case procedures

We assign students to "companies," with each group of four students representing a company.[2] One student is assigned the role of CEO of Goliath, and the remaining three students each assume one of the three divisional-manager roles (i.e., the Plastic Products, the Metal Products, and the Electronics Divisions of Goliath). The case materials are then handed out to the students, with the CEO receiving the instructions appropriate to the CEO, and each divisional manager receiving her/his respective instructions.[3] After receiving and reading the instructions, the CEO is required to select a transfer pricing policy – and then s/he receives the full set of instructions that are provided to the divisional managers to see the decisions they face. Divisional managers are then charged to

[2] We have used a number of strategies when the number of students is not divisible by four. For example, a company can have two CEOs, representing a transition of top management, or the instructor can serve as CEO for one or more companies. The least desirable option would be to eliminate a division.

[3] These materials are available in electronic form from the authors.