

SUBJECTIVITY AND FAIRNESS IN BONUS PLANS – A TRANSFER PRICING APPROACH

- study case -

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ABSTRACT

This case deals with a company in the recycling industry that faces the challenge of rapid organic growth in its customer base, as well as large capital investments. The company struggles with updating its transfer pricing system. The case illustrates how this leads to conflicts about bonus plans among division heads. The discussion of the case is open-ended. It specifically fosters understanding the role of operating leverage for profitability, as well as distributive fairness in bonus plans.

Keywords: Time-driven Activity-based Costing; teaching notes; transfer pricing; bonus plan; fairness.

1. INTRODUCTION

AMCE Ltd. recycles polyethylene terephthalate (PET) bottles and sells the recycled granulate to business-to-business (B2B) clients. On a monthly average, ACME collects and recycles 1,500 tons of PET bottles.

ACME cuts the crushed bottles into flakes, washes and dries them, sorts them by color, and then extrudes and melts the flakes into fresh granulate. 1 ton of collected PET will yield only 0.9 ton of fresh granulate due to scrap and contamination in the production process.

Transfer pricing

ACME runs its divisions as profit centers. Variable pay of the head of each division depends on the division's operating incomes.

Transactions among departments use full-cost transfer prices. On a daily basis, ACME's division 1 (D1) collects PET bottles from retail clients that have strong ties to D1. The clients, mostly supermarkets, pay a monthly fee to D1.

The fee results from the tons of PET collected, multiplied by the rate per ton of 50 EUR (the rate is set annually by the federal government). D1 charges ACME's division 2 (D2) a transfer price of 225 EUR per ton.

This transfer price reflects full costs of D1. D2 uses the bottles to produce new PET granulate. D2 gets its revenues from selling granulate in the global raw materials market to constantly varying clients at current market prices. The data below are a realistic approximation of typical monthly operations of D1 and D2:

D1 (bottle collection)	EUR
Revenues	
Revenues from clients (waste providers)	75,000
Revenues from D2	337,500
Total revenues	412,500
Costs of bottles (not granulate)	
Variable costs of bottles (per ton)	262,500
Fixed costs	75,000
Total costs	337,500
Operating income D1	75,000