

The conceptual measurement of profits, by Robin Lynch, Director of National Accounts Group, ONS

For many large companies in the United Kingdom, profits are made on a national basis, as part of a national business plan. To estimate value added by site, transfer prices for goods traded between sites within the company are necessary. This may be difficult. A different view of these transfer prices can move profits between sites according to the site production accounts. Another way of allocating profits by region, is to split profits down into their constituent parts. National estimates of profits can be allocated to sites by identifying and valuing flows of capital services between operating units of the enterprise. This will be difficult in national companies. So for example, for a company with activities spread across many sites, there will be flows of capital services from the service centres of the firm, allowing the marketing and sales units to operate effectively. In order to allocate profits by site, we must identify and value all the internal service flows, which contribute to final sales.

In the general case, we require an estimate of the capital services provided to operations not only from the local assets such as buildings and equipment, but also from the intangible assets of the firm. These will be items such as system software, databases, brand names, and as many as possible of the other items that account for the goodwill element of the value of a company. This allocation of profits to the internal capital services provided by intangible assets will allow a regional allocation of profits, apart from what might be called the extra entrepreneurial turn. This residual part of profits represents the contribution from more nebulous assets such as synergy and leadership.

Identifying corporate services is difficult, and there may be no good basis on which to value their flows. It is unlikely that a company will have estimates of the value of their complete stock of intangible assets in the asset register, and they may have no idea of how to estimate the annual flow of services from these assets to the operation of the company.

Even if an allocation of profits was possible, it is not clear how useful it is to allocate profits on this basis to regional points of product delivery. For every internal delivery of a capital service, there will be an equivalent payment for the service from the operational units to the centrally held asset. The price placed on this transaction will determine where the profit centre of the company lies. This price will be difficult to determine using arms length valuation using similar market transactions.

The above analysis is complicated further by the operations of multinationals. A household vacuum producer, with all manufacturing overseas, and only research and development, design, marketing and sales, and central services finance operations left in the UK, will be extremely difficult to 'regionalise'. Where are the profits made? The only sensible production function that can be estimated with confidence is a multinational one.