Transfer pricing

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In India, when the economy was opened up, Multinational Corporations shifted their focus to Asian region, more interestingly towards India as the potential hub for their products/ services. This called for framing of Transfer pricing strategies by MNC's /service industries, mainly the banking & insurance, to exploit the low labour costs, tax sops/ policies and of course the abundance of natural resources.

The very basics of pricing for a product or service dates back to the barter system, which laid the foundation for commercialization of usage of a product or service. This is followed by Comparative cost theory, which helped in ascertaining the worthiness of a product or service being exchanged for some other product or service.

One can very well understand the basic fact that the concept of transfer pricing has been in existence, ever since the products/ services started moving around and across the borders freely.

Only when the countries felt the need for market -driven economy, the corporate, associations started throwing light on the strategies for transfer pricing, which was not either thought nor given importance till the countries followed socialist form of economy/ protective policy, wherein many a products or services were simply outside the scope of pricing, i.e. at free of cost or at a subsidized price, which was not warranted and in fact such form affected the growth of Indian economy.

Like any other pricing strategy, transfer pricing is also influenced by demand and supply position of the concerned processes/entities. The pricing is placed at a place where the demand and supply interact each other and not only optimal pricing emerges out of the intersection, but also helps in optimizing the energies resources of an organization/ processes.

Need for Transfer Pricing

In India, when the economy was opened up, Multinational Corporations shifted their focus to Asian region, more interestingly towards India as the potential hub for their products/ services. This called for framing of Transfer pricing strategies by MNC's / service industries, mainly the banking & insurance, to exploit the low labour costs, tax sops/ policies and of course the abundance of natural resources.

This pricing policy helps in deciding the areas for concentration of business processes and hiving off / outsource the rest of the business processes. For transfer pricing to be effective, it is essential that the transactions at each stage is considered at arm's length price (ATP).

At each stage of business process, a margin / reward is added to the value added by the particular process (predecessor) and then passed on to the subsequent process (successor) and finally the product or service is priced to the customers.

Whereas in the conventional method, the profit margin is added only after accumulation of all costs of contributing processes / departments. This also enables real time assessment of performance of each processes/ centers, rather waiting for the periodic reviews/ analysis based on the historical data. As transfer pricing calls for Just in Time (JIT) method of monitoring of transaction flow, the correction at any process / centers becomes easier, without passing on the bugs to the successor processes.

Objectives

To identify "Best in Class" transfer pricing processes, which, when implemented, will lead member companies / constituents / strategic partners/ stakeholders to exceptional performance.

To create a cooperative and healthy competitive environment where full understanding of the performance and enablers of "best in class" transfer pricing processes can be obtained and shared at reasonable cost, however without losing the importance in the hierarchy / relationship.

To use the efficiency of the association/ teams / groups/ departments to obtain process performance data and related best practices with regard to transfer pricing.

To support the use of benchmarking to facilitate transfer pricing process improvement and the achievement of accuracy, timeliness and efficiency.

To update and assess the effectiveness the best practices being adopted and any modification / amendments to be resorted to.

Application Methods/Methodology

The pricing strategies may be based anyone of the following methods depending upon the requirement of the situation as may be

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warranted from time to time, nature of industry, type of transaction, tax shield required, performance parameters being developed and last but not the least the organization's zeal to work towards efficient administration of the system that is being developed to tackle both financial and non financial issues.

The transfer pricing methodology may vary from entity to entity / industry to industry, depending upon the importance being given to information technology (application of ERP /SAP solutions)

Few well-known methods are being discussed below :—

S. No.	Method	Explanatory Note
01	Going Rate/ Market price	The prevailing market price for the goods/ services as influenced by demand / supply position and considering the exchange of goods services at a arm's length distance (transpa-rent pricing) Where there is no market / the product/ service is new entrant to the business arena / organization, a pricing methodology has to be worked out which shall be just adequate to sustain in the market/ basket of services. Eg. The price charged by the competitor, say the MR Price.
02	Standard Rate/ Cost	A predetermined approach based on the past experience using scientific techniques which shall ensure to provide a decent pricing for the goods/services thus being delivered/ served as the case may be. Eg. The variable cost of a product/ service plus apportioned fixed costs among various centers / branches/ departments for using common asset/ centralized services of an entity.
03	At cost	Here one can rely on the adjusted cost estimates arrived at as in method 2 above. Or go by the actual expenditure incurred/ spent by the transferor / service provider . eg. The cost sheet prepared by the branch/ department / center may be taken as the base and it may be broken into man hour / days/ weeks/ months.
04	Cost Plus	In this case, we consider allowing an incentive to the constituent member for having delivered/ served the receiver / transferee. We can administer this by choosing either method - 2 or method -3 as discussed above and add a percentage(say 15%) which shall satisfy/act as an incentive for having contributed to the growth of the organization/ branch / department. Any incentive that is being offered should be framed on a premise that is just.
05	Working Back – Revenue	Here the Post tax profit of an entity / constituent is broken down based on the performance of Revenue centers under an entity. Suppose an entity reports Rs.100 lacs has its post tax profit, the same shall be shared among its revenue centers(say 3 centres).

Centre	Revenue/ sales generated (lacs)	Sharing pattern Ratio	Amt
Sigma	250.00	2.5/6.7	37.31
Delta	350.00	3.5/6.7	52.24
Gamma	70.00	.70/6.7	10.45
Total(a)	670.00		
Total Post Tax Profit (b)	100.00		100.00
Ratio for sharing (b/a)	100/670 =0.1493		

The methods as narrated above may be brought into two categories of pricing.

a) Bottom to Top approach

The methods 01-04 as above come under this category as one attempts to arrive at a price taking a base as zero and cost is built upon at various stages of production/ services and final pricing is arrived for consideration.

b) Top to Bottom approach

The method as in 05 above can be brought under this as the price for a department/branch/ center is worked back based on the performance of the entity taken as a whole and shared by the contributing departments/ centers/ branches based on their ultimate generation of revenue and the loss making department will be out for any share in the profit and instead it is penalized for non performance/ under performance. This method is framed on the premise that pricing for each product line/ division is already in place based on the methods as suggested in 01-04.

Various operation research tools and techniques like statistical sampling, moving averages, queuing theory, matrix, sensitive analysis will be helpful to attempt approximation/ perfection in pricing strategy.

Building Price Patterns - Presentation

Price administration based on either of the methods (01-04)/ category -1 as narrated above

a) Pricing Pattern

(Proc-ess-a) (Pro-cess-b) (Pro-cess-c) Profit Margin

Under Conven-tional Pricing method

b) Pricing Pattern

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Under Trans-fer Pricing method

Cost element involved in the respective process/centre/branch/department

Profit element involved in the respective process/centre/branch/departmet

One can note the fact that the profit margin changes between departments/ centers depending upon their contribution to the final product/ service.

Price administration based on either of the methods (05)/category -2 as narrated above.

Price of the Products/ services or Product line

Sigma	Delta	Gamma
250.00 lacs	350.00 lacs	70.00 lacs

Let us assume the above reflect the revenue generation by each product/service

Hypothetically, let us a consider the post tax profit an entity having the above product line is Rs.100 lacs

Post Tax Profit (in lacs

The same shall be shared among the product lines in the following proportion

Share of each segment (in lacs)

Sigma	Delta	Gamma
37.31	52.24	10.45

Let us consider four processes / departments in an entity, the transfer pricing helps ascertain, whether to retain or delink a process/ center as depicted below.

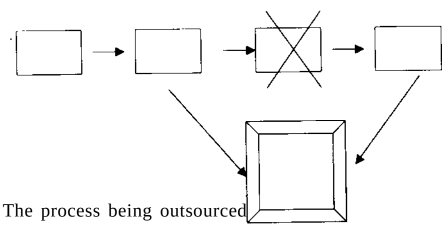
The four processes in an entity, before analysis

Now the entity wants do cost - benefit analysis of each and every process. The outcome of the analysis, let us for example, is do away with the process - 3 and outsource the same to reap the economies of transfer pricing.

The four processes in an entity, after analysis

Parameters

Parameters underlying the transfer pricing may be broadly categorized as below:—



The process being outsourced

- Demand / the basic need / the utility value of the business process/ service being considered
- Supply / the availability of such process/service/center/resources
- The elasticities of demand and supply being required/available
- The quality of service/ product/ constituents being required
- Geographical conditions
- Access to markets / Free movement of goods and services
- Socio Political environment prevailing in a region/ state
- The state of the economy, viz - boom / recession, inflation/ deflation etc
- Policy framework of the state/ region -tax reforms/ tax administration

Areas for Implementation

The transfer pricing strategies can be implemented / compared between

a) two or more different entities (domestic Vs domestic, domestic Vs international, international Vs international)
b) two or more different processes/ centers within the organization
c) two or more homogenous processes/ centers both within the organization / outside the organization
d) Holding company Vs subsidiaries
e) Industrial norms Vs Entity's norms

Although it attaches commercial value to each process/ centers/ entities, it can be extended to non -profit making organizations too for effective administration of internal checks / controls.

Uses

- Performance appraisal for the constituents/ members/ departments/ centers.
- Throws light on the need for retaining a constituent under its own fold or to outsource a particular activity or group of activities.
- To decide about continuance either in full or part. That is de linking, merging / de merging members.

- To look into the possibility of vertical integration/backward integration.
- Enables effective tax planning by corporates / service providers.
- Facilitates better tax administra-tion by Revenue departments.
- Global outlook for businesses / processes is enhanced.
- Helps in creating hub in a region based on the potentialities, tax structure and double taxation agreements between regions & Helps in evaluating Exit options from a particular region.
- Helps in understanding the value or importance of each serving / contributing centers/ departments.
- Enables conservation of scarce resources, human resources, foreign exchange, cash & machineries etc.
- Real time decisions are taken on various issues affecting the pricing, using Just In Time (JIT) approach and help in loss minimization, to remove inefficiencies in the business processes and help augment supplies.
- One need not wait till the financial reports are out for performance analysis of depart-ments/ segments/ revenue centers, as the data can be tracked immediately without much loss of time.

Administration of the System

Need for a separate department

- for drawing pricing strategies for the transactions/ constituent members.
- for creating awareness among the all the constituents of the system as a whole.
- for efficient and effective administration of the pricing strategy as a whole.
- for monitoring the transaction flow report anomalies.
- for its effective implementation at all levels/ centers.
- for review of the whole or part of the pricing strategy being framed.
- for incorporating / delinking the claimants.

Polices and Procedures/manuals on Transfer Pricing

There shall be drawn a policy on the subject matter and rules and procedures for effective understanding of the concept and its implementation.

Security Policy

As the department thus conceived is prone to mischievous acts of persons, who are either deprived of their share of reward or persons who want throw the spanner on some one to cover its weaknesses/ non performance, there shall be laid down procedures for proper security of the documents/ systems etc.

Staffing Arrangements

Once the department is positioned in the organization hierarchy, the same shall be staffed adequately to deliver its own commitments as may be chalked out by the management.

Infrastructure

In order to be able to serve the organization as a whole, the department shall be provided with latest/ updated internet/intranet, telecommunication devices for effective deliverance. This shall call for introduction of new softwares or modifications in the existing softwares being used by the entities.

Training and Development

All the constituents, sub-constituents vested in a transaction shall be assisted by way of training on the latest techniques on transfer pricing in order to be able to update themselves and to demand their right share of profit or otherwise, if the same is justified. Debates / deliberations should be arranged at regular intervals to fine tune the system of administrating the pricing policy.

Formation of Transfer Pricing Committee

In order to avoid infighting among the constituents with regard to sharing of revenues/ profits/losses, there shall be formed a committee which shall be spearheaded/ chaired by the senior most in the organization hierarchy, who has relevant expertise and having its members chosen by the chairman. All disputes shall be addressed to the committee and the committee should deliver its verdict within such time as is reasonable going by the subject under dispute.

Audit of Transfer Pricing

Policies, Procedures, bench marks & its application on the constituents / members should be subjected to thorough audit so that.

- no loopholes in the pricing are found.
- for removing bottlenecks in the administration of the system of pricing.
- to understand the need for review in the light of changes in tax laws, inter-state agreements, change in the product lines, shift in geographical focus.
- To enable the tax administrators for placing their computations of tax rates etc based on the auditors findings, observations etc.

Reporting System

This would call for matrix form of organization structure as it may have to seek assistance cutting across the various levels / departments, calling for parallel/dual reporting for exchange of views/information.

Guidelines

One can seek help from the following centers for transfer pricing solutions both international and domestic pricing issues.

- Organization for Economic Co-operation andDevelopment.
- The Transfer Pricing Management Benchmarking Association is an association that conducts benchmarking studies to identify the best transfer pricing processes that will improve the overall operations of the members.
- Transfer Pricing Network Developed by Economic Consulting Services, LLC. □