METHODS OF TRANSFER PRICING

MEANING

International Transfer Pricing is the general term for pricing of cross border, intra firm transactions between related parties.

Acc. to IAS 14 on segment reporting:

transfer pricing is –

"the pricing of products or services between industry segments or geographic area."

BASE FOR INTERNATIONAL TRANSFER PRICING

“Arm’s Length Principle” (ALP)

ALP uses the behaviour of independent parties as a guide or benchmark to determine the allocation of income and expenses in international dealings between associated enterprises.

METHODS OF TRANSFER PRICING

- CONVENTIONAL METHODS
  - COST BASED METHODS
  - MARKET PRICE BASED METHODS
  - OTHER METHODS
- NON-CONVENTIONAL METHODS
  - TRADITIONAL TRANSACTIONAL METHODS
  - TRANSACTIONAL PROFITS METHOD
  - ECONOMIC ANALYSIS
  - MATHEMATICAL PROGRAMMING

I. NON-CONVENTIONAL METHODS

I. Traditional Transaction Methods

1. Comparable Uncontrolled Price Method
2. Resale Price Method
3. Cost Plus Method

COMPARABLE UNCONTROLLED PRICE METHOD (CUP METHOD)

The price charged between independent parties forms the basis for determining the arm's length price under this method.

A CUP may arise where:

1. Internal comparable
2. external comparable

Internal Comparable

- Member of the group
- Buys/sells particular product , in similar quantities, under similar terms , in similar markets
- From/to Arm's Length Parties.

External Comparable

- One Arm's Length Party
- Buys/sells particular product , in similar quantities, under similar terms , in similar markets
- From/to another Arm's Length Party.

EXAMPLE:

Zolex, a UK co. sells commodity Zincox directly to a French subsidiary Francozen for its internal consumption & an average daily French price is readily available which is in terms of GBP is equal to 280 GBP per ton.

This price however represents a delivered price which includes-

freight at GBP 16 per ton

Duties at GBP 14 per ton

The transfer price would be:

Avg. daily french transaction price: GBP 280

Less: adj. for freig GBP 16

adj. for duties : GBP 14 GBP (30)

ADJUSTED TRANSFER PRICE: GBP 250

2. RESALE PRICE METHOD

Under this method, Arm's Length Price of goods acquired by a member of group in a non arm's length transaction is determined by reducing the price realized on resale of goods by that member of group to an arm's length party, by a gross margin which should allow the seller to:-

- Recover its operating cost
- Earn profit

EXAMPLE

Electronics India net sales to arm's length parties is $30000, the total cost of warranty and promotional material on these sale is$ 120 and $ 200. Nitco earns a 15% margin on sales.

The transfer price will be:

Electronic india's net sales to ALP: $30000

Comparable margin: $4500

Adjustments:

Promotional cost: $ 120

Warranty cost: $ 200

ADJUSTED SALES PRICE: $ 4820

3. COST PLUS METHOD

This method begins with the costs incurred by a supplier of a product or service to a non arm’s length party and a comparable gross mark up is then added to these costs.

COMPUTATION OF ARM'S LENGTH PRICE UNDER COST PLUS METHOD

1. Determine Direct and Indirect costs of production in respect of goods transferred to an associated enterprise.
2. Determine Normal gross profit from transfer of similar goods in a comparable uncontrolled transactions.
3. .Make necessary adjustments in normal gross mark up.
4. Add the normal gross mark up in costs referred in Step1
5. Adjusted price is Arm's Length price.

Transactional Profit Methods

1. Profit Split Method
2. Transactional Net Margin Method
3. Comparable uncontrolled transaction method

1. PROFIT SPLIT METHOD

- This method starts by identifying the combined profit to be split between the related parties in a controlled transactions. This profit is then split between the parties in the following ways:-

- Residual Analysis
- Contribution Analysis

RESIDUAL ANALYSIS

- **A Residual profit split is performed in two stages:-**

1. **The allocation of a return to each party for readily identifiable functions.**
2. **The residual profits/loss are then allocated between the parties based on the relative contribution of the parties taking into consideration any information available .**

CONTRIBUTION ANALYSIS

Under it, the total profit earned by the parties from a controlled transaction is divided among them on the basis of their relative contribution.

However, since relative contributions are difficult to quantify , so Residual Analysis is better.

2. TRANSACTIONAL NET MARGIN METHOD (TNMM)

- It is also called Comparable Profit method.
- It compares the net profit margin earned by related parties from a controlled transaction with the net profit margin earned by Arm's Length Parties from similar transactions relative to an appropriate base.
- The results of this method resemble the results of a resale price/cost plus method.

3.COMPARABLE UNCONTROLLED TRANSACTION METHOD

This method sets the loyalty rate by reference to uncontrolled transaction in which the same or similar intangibles are transferred under similar circumstances.

III. ECONOMIC ANALYSIS

The tools of micro economics analysis were first applied to the problem of interdivisional transfer pricing by "Hirshleifer (1956)".

He concluded that in a competitive market, Marginal Cost Pricing would produce goal congruent results through autonomous decision making by two divisions.

Operational difficulties:

- Difficulty in computation
- Capacity constraints
- Autonomy of units
- Incentive to overstate marginal cost

IV. MATHEMATICAL PROGRAMMING

- Linear relationship is established between variables and then transfer price is determined on the basis of linear equation.
- In it assumptions regarding linear costs and price are made.

CONVENTIONAL ACCOUNTING MEASURES

Cost based methods			
Full costs	Modified full cost	Standard cost	Partial cost

Market price based methods

Based on semi-finished product	Based on ultimate market price

Other methods

Negotiated price	Target profit price	Dual pricing

Conclusion

These are the methods which are used to find out the Arm's length price for transferring the goods and services between the associated enterprises operating in different countries.

THANK YOU