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TRANSFER PRICING- A STUDY OF TRANSFER PRICING METHOD USED BY SELECTED COMPANIES

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ABSTRACT

The modern business has become very complex as a result of liberalization, privatization and globalization, which has led to an increase in the pace of diversification among companies. The revolution of LPG has also led to the practice of going for domestic and international mergers by various corporate houses. These mergers, actually, change the organization structure of the enterprise, making it more oriented towards an SBU structure whereby an organization is divided among various units which are strategically independent by nature. Hence any inter-division or inter-unit/segment sale is accounted for. And to account for these inter segment sales, the concept of transfer pricing came into advent. Transfer pricing refers to the pricing of contributions (assets, tangible and intangible, services, and funds) transferred within an organization. The challenging task is to decide upon the price to be charged for all the inter segment sales. There are various methods of pricing the inter segment transfers viz. Market based transfer pricing, Cost based transfer pricing and Negotiated transfer pricing. Various domestic and multinational corporations are using one method or the other. The primary motive of this research paper is to identify the method of transfer pricing used by various companies. For satisfying this purpose, a total of 35 companies have been chosen as a sample collected from various sectors like FMCG, Chemical Industry, Pharmaceutical Industry, Automation, Manufacturing, Textiles and Timber, Building material and electronic companies. The study reveals the prevalence of Market price as a basis of valuing all the inter segment sales among the companies under survey. A total of 17, out of the 35 companies surveyed, admitted that they are using Market price as a basis to value their inter segment sales.

KEYWORDS

Organization for Economic Co-operation and Development (OECD), Arm's length Price, Transfer Pricing Manipulation, Market-based transfer pricing.

INTRODUCTION

The modern business has become very complex as a result of liberalization, privatization and globalization, which has led to an increase in the pace of diversification among companies. Some of the examples of the companies adopting the strategy of diversification, and thereby reaping the benefits of synergy are Hall Mark, ITC etc. The revolution of LPG has also led to the practice of going for domestic and international mergers by various corporate houses. These mergers, actually, change the organization structure of the enterprise, making it more oriented towards an SBU structure whereby an organization is divided among various units which are strategically independent by nature. Hence any inter-division or inter-unit/segment sale is accounted for. And to account for these inter segment sales, the concept of transfer pricing came into advent. This study basically enumerates and discusses in detail the concept of transfer pricing explaining various methods used and practices adopted among various corporate entities worldwide.

Transfer pricing refers to the pricing of goods and services transferred within an organization. It is the price which is charged for the transfers made by one department/division in the organization to another. Since the prices are set within an organization (i.e. controlled), the typical marketing mechanism followed for establishing prices for transactions between third parties may not apply. Hence, the amount used in accounting for transfer of goods or services from one responsibility centre to another or from one company to another which belong to the same group, is termed as "Transfer Price". Hence, any inter-division or inter-unit/segment sale is accounted for. The role of transfer price is to provide valuations for intermediate products and services so as to facilitate transactions across profit centres within a firm. For example, goods from production division may be sold to the marketing division, or goods from a Parent company may be sold to a foreign subsidiary, with the choice of the transfer price affecting the division of the total profit among the parts of the company. Transfers between related parties are also known as "Inter company transactions".

ORGANISATION FOR ECONOMIC CO-OPERATION & DEVELOPMENT (OECD)

Organization for Economic Co-operation & Development (OECD) is an international organization that came into being in 1961. The organization has 30 full members: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Organization for Economic Cooperation and Development (OECD), released the final version of its transfer pricing guidelines. The guidelines are not law, and member countries are encouraged (but not required) to follow them. Nonetheless, most member countries do not have their own detailed transfer pricing regulations and prior OECD guidelines on transfer pricing have been followed by member countries.

OBJECTIVES OF THE STUDY

To identify and compare the transfer pricing methods used by various organizations for their inter segment sales.
To identify the most prevalent and widely used method of transfer pricing.

REVIEW OF LITERATURE

A number of studies have been conducted on the subject and some of them have been listed below:

Chris (1998) has empirically examined the effects of accountability and performance evaluation scheme on negotiation task. 240 American and 160 Australian subjects negotiated significantly higher joint profits & fewer differences between final offers (DBFO) under high accountability & firm-based performance evaluation.

Ljilja & Vesna (2000) dealt with the analysis of some characteristics of transfer pricing methods. This estimation of adequacy of the methods has been illustrated on an example of hypothetical enterprise with decentralized structure and a large number of profit centres with possible internal transfer of products and services.

Markus, Thomas (2005) in this paper deployed Transaction cost economics (TCE) to elaborate the shortcomings of "mainstream" transfer pricing in multinational firms. Departing from the notion that multinationals increasingly (re)-organize their business along multinational value chains irrespective of jurisdictional borders, the paper discussed the nature of the multinational firm and the problem of choosing the right intra-group transfer price. The mainstream transfer pricing approach derived from the Arm's length principle is deemed inappropriate for globalized MNEs. Referring to the value chain model, the paper has suggested "entrepreneurial coordination" as the key performance feature to be used for valuing business activity and for allocating for tax transfer pricing purposes-standard mark-ups and residual profits along the value chain.

Peter, John, (2000) revealed that the achievement of overall corporate goals is the highest ranked transfer pricing objective. Market Pricing is the most widely used method among the institutions. Salient differences were however found between the transfer pricing choices of banks on the one hand and the building societies on the other.

Sahay, Savita (2003) analyzes a simple transfer-pricing policy based on the actual cost of production. They showed that the performance of actual cost-based transfer pricing can be improved by using an additive mark-up above the unit production cost. The optimal additive mark-up is shown to increase with increasing prices for the firm's product, and decrease with the cost of the supplying division's investment.

Tim et al (2003) in this paper examined transfer pricing in multinational firms when individual divisions face different income tax rates. Assuming that a firm decouples its internal transfer price from the arm's length principle used for tax purposes, the study analyzed the effectiveness of alternative pricing rules under both cost and market based transfer pricing. This analysis characterized optimal intra company discounts as a function of the market parameters and divisional tax rates.

RESEARCH METHODOLOGY

The companies are required to disclose information relating to the method of transfer pricing in their annual reports under significant accounting policies. For satisfying the requirements of the research objective, a sample of 35 companies from FMCG, Pharmaceuticals, buildings, timber, textiles, manufacturing and electronics sector was selected and the transfer pricing method used by them was identified reviewing their annual reports for the year 2007-08.

TRANSFER PRICING METHODS

There are several different methods for determining transfer prices. These can be either Market-based, i.e. equivalent to what is being charged in the outside market for similar goods, or it can non-market based. Importantly, two-thirds of the managers say their transfer pricing is non-market based.

There are three main methods for determining transfer prices:

Market -based transfer prices

Cost-based transfer prices.

Negotiated transfer prices.

MARKET-BASED PRICES

Top management may choose to use the price of a similar product or service publicly listed in, say, a trade association website. Also, top management may select, for the internal price, the external price that a subunit charges to outside customers. In the global business environment today, it is not unusual for subsidiaries of larger companies to conduct business transactions with one another, as if they are not all part of the same corporate family. When two companies that are affiliated by a connection through a parent company, the type of business they transact are often referred to as an arm's length *transaction*. The price per unit that is extended for the items bought and sold is referred to as an arm's length price. Arm's length price means a price that would be obtainable and the transaction takes place between independent parties in uncontrolled conditions. The arm's length price shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction, namely:

Comparable Uncontrolled Price (CUP) Method

The CUP Method compares the price at which a controlled transaction is conducted to the price at which a comparable uncontrolled transaction is conducted. The arm's length principle is simply determined by the sale price between two unrelated corporations. Such comparable transactions fall into two categories: External comparables and internal comparables. The former is a comparable uncontrolled transaction in the purest sense of the term-If Company A, in France, sells widgets to its subsidiary A (sub)in Turkey, then an external comparable transactions would be the sale of widgets from French Company B to Turkish Company C(an unrelated enterprise) on identical terms as the trade between A & A (sub). An internal comparable transaction, then would be either trade of widgets between Company A and Company C, or the trade of widgets between Company B and Company A (sub), with the term "internal" referring to the fact that one of the parties involved in the tested transaction is also involved in the Comparable uncontrolled transaction.

Resale Price Method

The Resale Price (RP) is found by working backwards from transactions taking place at the next stage in the supply chain, and is determined by subtracting an appropriate gross mark-up from the sale price to an unrelated third party, with the appropriate gross margin being determined by examining the conditions under which the goods or services are sold and comparing said transaction to other third party transactions.

PROFIT SPLIT METHOD

The Profit Split method (and its derivatives, including the comparative and Residual Profit split methods) is applied when the businesses involved in the examined transaction are too integrated to allow for separate evaluation, and so the ultimate profit derived from the endeavor is split based on the level of contribution- itself often determined by some measurable factor such as employee compensation, payment of administration expenses etc- of each participants in the project.

TRANSACTIONAL NET MARGIN METHOD

The Transactional net margin method (TNMM) in Transfer pricing compares the net profit margin of a taxpayer arising from a non-arm's length transaction with the net profit margins realized by arm's length parties from similar transactions; and examines the net profit margin relative to an appropriate base such as costs, sales or assets.

This differs from the cost plus and resale price methods that compare gross profit margins. However, the TNMM requires a level of comparability similar to that required for the application of the cost plus and resale price methods. Where the relevant information exists at the gross margin level, taxpayers should apply the cost plus or resale price method.

Because the TNMM is a one-sided method, it is usually applied to the least complex party that does not contribute to valuable or unique intangible assets. Since TNMM measures the relationship between net profit and an appropriate base such as sales, costs, or assets employed, it is important to choose the appropriate base taking into account the nature of the business activity. The appropriate base that profits should be measured against will depend on the facts and circumstances of each case.

Cost-Based Transfer Price

In many situations external reference points do not exist, for example, when products are produced uniquely for internal markets and outside selling is either impossible because of a lack of customers or prohibited because of strategic concerns. In such cases, production cost is used as the base for setting the price.

Prices can be based on:

FULL-COST BASES: In practice, many companies use transfer prices based on full cost. To approximate market prices, cost-based transfer prices are sometimes set at full cost plus a margin. Using full cost based transfer prices requires an allocation of each subunit's fixed costs to products.

VARIABLE-COST BASES: Herein, under this method, the variable cost is used as a basis for determining transfer price.

COST PLUS METHOD: This method is generally used for the trade of finished goods and is determined by adding an appropriate mark-up to the costs incurred by the selling party in manufacturing/purchasing the goods or services provided, with the appropriate mark-up being based on the profits of other companies comparable to the tested party.

Negotiated Transfer Price

Negotiated transfer prices result from a bargaining between selling and buying subunits. In this way the parties are free to set the price that satisfies both. Often this negotiation will be based on information about market prices and internal costs.

ANALYSIS & INTERPRETATION

DATA COLLECTED FROM THE ANNUAL REPORTS OF VARIOUS MULTINATIONAL CORPORATIONS

The annual reports of various companies for the year 2007-08 have been used to elicit information with respect to the method of transfer pricing used by them.

Since as per the accounting standards given, AS- 17 relating to segment reporting and related party disclosures, all the companies are supposed to mandatorily disclose such information in their annual reports. Below given is a brief introduction to all the thirty-five companies involved in the survey:

FMCG (FREE MOVING CONSUMER GOODS INDUSTRY)

1. Hindustan Unilever Ltd.: Hindustan Unilever Limited formerly Hindustan Lever Limited, is India's largest consumer products company and has an annual turnover of over Rs 13,000 crores (calendar year 2007). It was formed in 1933 as Lever Brothers India Limited and came into being in 1956 as Hindustan Lever Limited through a merger of Lever Brothers, Hindustan Vanaspati Mfg. Co. Ltd. and United Traders Ltd. It is headquartered in Mumbai, India.

2. Itc (Indian Tobacco Company): ITC Limited which previously stood for Imperial Tobacco Company of India Limited is an Indian conglomerate with a turnover of US $ 4.75 billion. It ranks third in pre-tax profit among India's private sector corporations.

3. Britannia Industries: Britannia Industries Limited is an Indian company based in Kolkata that is famous for its Britannia and Tiger brands of biscuit, which are highly recognized throughout the country. Britannia is India's largest biscuit firm, with an estimated 38% market share. The Company's principal activity is the manufacture and sale of biscuits, bread, Rusk, cakes and dairy products.

4. Asian Paints: Asian Paints is India's largest paint company that operates in 21 countries and has 29 paint manufacturing facilities in the world servicing consumers in over 65 countries.

5. Dabur India: Dabur India Ltd. is the fourth largest FMCG Company in India. Dabur deals in Health care and Personal care products. Today, Dabur has a turnover of Rs.1899.57 crores.

6. Nestle India: Nestlé India is a subsidiary of Nestlé S.A. of Switzerland. With seven factories and a large number of co-packers, Nestlé India is a vibrant Company that provides consumers in India with products of global standards and is committed to long-term sustainable growth and shareholder satisfaction.

7. Reckitt Benckiser: Reckitt Benckiser plc (LSE: RB) is a global consumer goods company, making and marketing home, health and personal care products. Headquartered in Slough, near London, UK, it has operations in over 60 countries, including 42 manufacturing facilities, and sales in nearly 200 countries.

8. Titan: Titan Industries is the world's fifth largest and India's leading manufacturer of watches. The company has manufactured more than a 100 million watches till date; and has a customer base of over 80 million. The umbrella brand Titan is one of India's leading watch brands that brought about a paradigm shift in the Indian watch market, offering quartz technology with international styling.

9. Johnson & Johnson: Caring for the world, one person at a time... inspires and unites the people of Johnson & Johnson. The company embraces research and science - bringing innovative ideas, products and services to advance the health and well-being of people. Employees of the Johnson & Johnson Family of Companies work with partners in health care to touch the lives of over a billion people every day, throughout the world.

CHEMICAL COMPANIES

10. Pidlite Industries: Since its inception in 1959, Pidilite Industries Limited has been a pioneer in consumer and specialties chemicals in India. Over two-third of the company's sales come from products and segments it has pioneered in India.

11. BASF: In view of India's growing industrialization, BASF had envisaged the growth potential of the Indian chemical industry and embarked on its plan to be a notable player in this market with its high technological products.

12. The Dow Chemical Company: The Dow Chemical Company is an American multinational corporation headquartered in Midland, Michigan. As of 2007, it is the second largest chemical manufacturer in the world by revenue (after BASF) and as of February 2009, the third-largest chemical company in the world by market capitalization (after BASF and DuPont).

13. Sinopec: China Petroleum & Chemical Corporation is one of the major petroleum companies in China. Sinopec's business includes oil and gas exploration, refining, and marketing; production and sales of petrochemicals, chemical fibers, chemical fertilizers, and other chemical products; storage and pipeline transportation of crude oil and natural gas; import, export and import/export agency business of crude oil, natural gas, refined oil products, petrochemicals, and other chemicals. In 2009, it was ranked 9th by Fortune Global 500 becoming the first Chinese corporation to make the top ten.

14. Chevron Corporation: Chevron Corporation (NYSE: CVX) is the world's fourth largest non-government energy company. Headquartered in San Ramon, California, USA, and active in more than 180 countries, it is engaged in every aspect of the oil and gas industry, including exploration and production; refining, marketing and transport; chemicals manufacturing and sales; and power generation.

15. Eastman Kodak Company: Eastman Kodak Company (NYSE: EK) is a multinational US corporation which produces imaging and photographic materials and equipment. Long known for its wide range of photographic film products, Kodak is re-focusing on two major markets: digital photography and digital printing.

16. Cytec Industries: Cytec Industries Inc. is a global specialty chemicals and Materials Company focused on developing, manufacturing and selling value-added products.

17. NOVA Chemicals: NOVA Chemicals Corporation is a leading plastics and chemical company headquartered in Calgary, Alberta, with Executive Offices in Moon Township, Pennsylvania. It was founded in 1954. NOVA Chemicals' products are used in a wide variety of applications, including food and electronics packaging, industrial materials, appliances and a variety of consumer goods.

18. Air Products & Chemicals: Air Products and Chemicals, Inc. is an international corporation whose principal business is selling gases and chemicals for industrial uses. Air Products' headquarters is in Allentown, Pennsylvania, in the Lehigh Valley region of Pennsylvania, in the United States. Air Products is the Lehigh Valley's third largest employer, after Lehigh Valley Hospital and St. Luke's Hospital.

PHARMACEUTICAL

19. Glaxo Smithkline: GlaxoSmithKline is a United Kingdom-based pharmaceutical, biological, and healthcare company. GSK is the world's third largest pharmaceutical company and a research-based company with a wide portfolio of pharmaceutical products covering anti-infective, central nervous system, respiratory, gastro-intestinal/metabolic, oncology, and vaccines products. It also has a Consumer Healthcare operation comprising leading oral healthcare products, nutritional drinks, and over the counter medicines. It is listed on the London Stock Exchange and is a constituent of the FTSE 100 Index.

20. Abbott Laboratories: Abbott Laboratories is a diversified pharmaceuticals health care company. It has 72,000 employees and operates in over 130 countries. The corporate headquarters are in Abbott Park, Illinois, located near North Chicago, Illinois.

21. Chugai Pharmaceuticals Ltd.: Chugai Pharma USA LLC is a research-based, global pharmaceutical company that discovers and develops innovative therapeutic products.

22. CSL: CSL, a pharmaceutical industry.

23. UCB: UCB is a global biopharma focusing on severe diseases in three therapeutic areas.

24. Baxter International: Baxter International Inc., is an American health care company with headquarters in Deerfield, Illinois. The company primarily focuses on products to treat hemophilia, kidney disease, immune disorders and other chronic and acute medical conditions.

25. Divi's Laboratories Ltd.: Established in the year 1990, with Research & Development as its prime fundamental, Divis Laboratories focused on developing new processes for the production of Active Pharma Ingredients (APIs) & Intermediates. The company in a matter of short time expanded its breadth of operations to provide complete turnkey solutions to the domestic Indian pharmaceutical industry.

26 Dr. Reddy's Lab: Established in 1984, Dr. Reddy's Laboratories (NYSE: RDY) is an emerging global pharmaceutical company.

AUTOMATION

27. Rockwell Automation: Rockwell Automation is a global provider of industrial automation, power, control and information solutions. Brands in industrial automation include Allen-Bradley and Rockwell Software.

MANUFACTURING

28. H.B. Fuller: H.B. Fuller is a leading worldwide manufacturer and marketer of adhesives, sealants, paints and other specialty chemical offerings.

29. Avecia: Avecia is a leading private biotechnology company focused on the development and manufacture of innovative biotechnology-based medicines.

30. Agrium: Agrium Inc. is a major Retail supplier of agricultural products and services in North and South America, a leading global Wholesale producer and marketer of all three major agricultural nutrients and the premier supplier of specialty fertilizers in North America through our Advanced Technologies business unit. Agrium's strategy is to grow across the value chain through acquisition, incremental expansion of its existing operations and through the development, commercialization and marketing of new products and international opportunities.

TEXTILES

31. PPG Industries: PPG Industries is a leader in its markets; is a streamlined, efficient manufacturer; and operates on the leading edge of new technologies and solutions.

32. Century Textiles Industries Ltd.: Century Textiles & Industries Limited, Mumbai was incorporated in the year 1897. Till 1951 it had only one industrial unit - Cotton Textile Mills. Since then the Company has been making rapid progress in widely diversified fields. At present, the company is not only the trend setter in Cotton Textiles but has also made a remarkable presence in Yarn, Denim, Viscose Filament Rayon Yarn, Timecards, Caustic Soda, Sulfuric Acid, Salt, Cement and Pulp & Paper.

TIMBER

33. Plum Creek Timber Company: Plum Creek Timber is the largest private landowner in the United States. Most of its lands were originally purchased as timberland.

ELECTRIC

34. Sanyo: SANYO Electric Co., Ltd. is a major electronics company and member of the Fortune 500 whose headquarters is located in Moriguchi, Osaka prefecture, Japan. Sanyo targets the middle of the market and has over 324 offices and plants worldwide' together employing more than 11,000 employees.

BUILDING MATERIAL

35. Sherwin Williams Company: The Sherwin-Williams Company is an American company in the general building materials industry. The company primarily engages in the manufacture, distribution, and sale of coatings and related products to professional, industrial, commercial, and retail customers primarily in North and South America.

FINDINGS

Table 1 attached with the Reference section gives the description, on an individual basis, for the method used by various companies under survey. The following is the enumeration of the outcome or result of the research undertaken:

DISCLOSURE IN ANNUAL REPORTS (Refer Table 2)

A sample of 35 companies form part of the research for determining the transfer pricing method used by various companies as disclosed in their annual reports. The following are the results:

Out of the total thirty-five companies involved in the study, two companies are found using Cost or less (any provision for impairment).

A total of five companies advocate usage of Cost method for inter segment sales.

Three companies use Cost Plus method.

One Company named Rockwell Automation use either Cost or Cost Plus method based on the requirement.

A total of 17 companies use market price method and seven companies use arm's length price.

CONCLUSION

Transfer pricing is portrayed as a technique for optimal allocation of costs and revenues amongst divisions, subsidiaries and joint ventures within a group of related entities. Such representations of transfer pricing simultaneously acknowledge and occlude how it is deeply implicated in processes of wealth retentiveness that enable companies to avoid taxes and facilitate the flight of capital. The research study undertaken as a part of this research paper is primarily focused upon identifying the transfer pricing methods used by various companies and thereby adjudging the method that is most prevalent in use. The research identified market price method as the most widely used method of transfer pricing.

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APPENDIX

TABLE 1: METHOD OF TRANSFER PRICING USED BY VARIOUS COMPANIES AS DISCLOSED IN THE ANNUAL REPORTS

S. No.	COMPANY	METHOD USED
1	Hindustan Unilever Ltd.	Market led price
2	ITC	At Market price OR Where market price is not available at terms agreed by both parties.
3	Britannia	Market price
4	Asian Paints	Arm's length price
5	Dabur	Market price
6	Nestle India	Market price
7	Air products & chemicals	Market price
8	Reckitt Benckiser	Arm's length basis
9	Sanyo	Cost plus
10	Titan	Arm's length
11	Johnson & Johnson	Market price
12	Glaxo smithkline	Cost less any provision for impairment
13	Abbott Laboratories	Standard cost
14	Chugai pharmaceuticals Ltd.	Cost or less
15	CSL	Current market prices
16	UCB	Arm's length price
17	Baxter International	Arm's length price
18	Divi's Laboratories Ltd.	Arm's length price
19	Dr. Reddy's lab	Arm's length price
20	Rockwell Automation	Either at Cost or Cost Plus
21	Sherwin Williams Company	Manufactured Cost
22	Plum Creek Timber Company	Market price
23	Century Textiles Industries Ltd.	Factory Cost
24	Pidlite Industries	Cost Plus
25	BASF	Market Price
26	The Dow Chemical Company	Cost
27	SINOPEC	Market Price
28	Chevron Corporation	Market Price
29	PPG Industries	Market Price
30	Eastman Kodak Company	Market Price
31	Cytec Industries	Cost
32	H.B. Fuller	Cost plus a markup
33	Agrium	Market Prices
34	Nova Chemicals	Market Prices
35	Avecia	Market Price

TABLE 2: FINDINGS

Method Chosen	Number of companies using the method	Percentage
Cost or less	2	6
Cost	5	14
Cost Plus	3	9
Either at cost or cost plus	1	3
Market price	17	48
Arm's length price	7	20
Total	35	100

Source: Annual reports (2007-08)

REQUEST FOR FEEDBACK

Esteemed & Most Respected Reader,

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Hoping an appropriate consideration.

With sincere regards

Thanking you profoundly

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Sd/-

Co-ordinator