Industry Benchmarking for Select Industries

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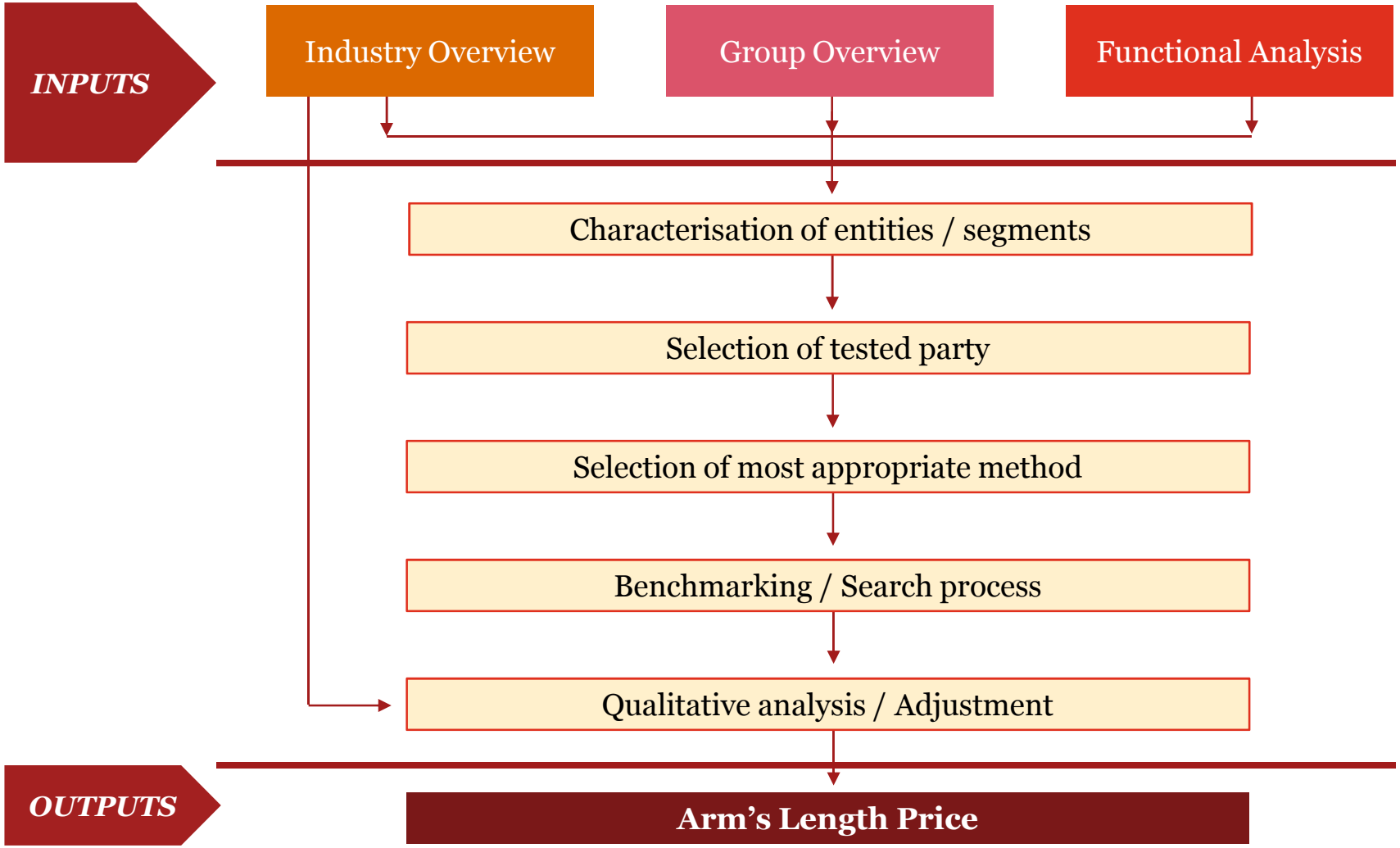
Transfer Pricing Jigsaw

Summary of benchmarking process



Industry Overview

Why do we need Industry Overview

- Assists in understanding the clients relative positioning in the industry vis-à-vis other players
- Helps in screening factors when undertaking a comparables search – qualitative analysis
- Provides overall justification of clients financial results

Structure of Industry Overview

- About the industry (Introduction, Background)
- Size and Structure
- Industry drivers
- Competitive landscape
- Regulatory environment
- Key trends
- Key challenges
- Way forward or Outlook
- Summary

Functional Analysis and Typical Business Models

FAR to Characterisation…a journey

- Functional analysis is central to any transfer pricing work
- Performing a functional analysis exercise will give you an in-depth understanding of the business
- Done properly, it will provide:
- Right characterization of the entities
  - guidance on choice of methodology
  - parameters for establishing comparability

A functional analysis facilitates the characterisation of the transactions between AEs after taking into account their functions, assets and risks and assists in establishing a degree of comparability with similar transactions in uncontrolled conditions

Typical Business Models

Manufacturer

- Full fledged Manufacturer
- Licensed Manufacturer
- Contract Manufacturer
- Toll Manufacturer

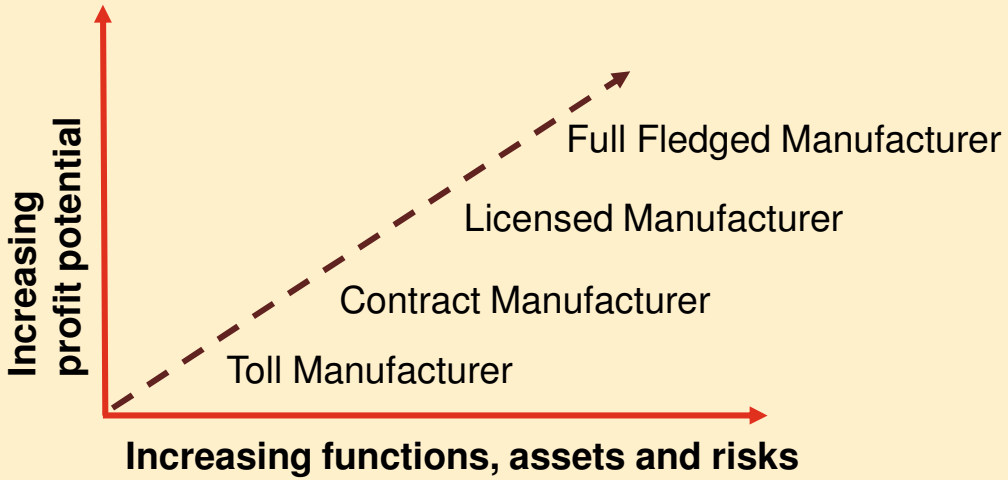
Distributor

- Full Fledged Distributor
- Low Risk Distributor
- Commission Agent

Service Provider

- Entrepreneur Service Provider
- Captive Service Provider

Typical manufacturing models



Parameters	Full Fledge Manufacturer	Licensed Manufacturer	Contract Manufacturer	Toll Manufacturer
Produces on	own behalf	own behalf	somebody else	somebody else
Intellectual Property	owns the IP	licenses the IP	does not own	does not own
Materials	owns	Owns	Owns	does not own

Manufacturing - Functions, Assets and Risk Analysis

FAR	Manufacturer			
	Full fledge	**License**	**Contract**	**Toll**
FUNCTIONS				
Owns non-routine technology i.e. IP (Research & Development)	Y	N	N	N
Owns Material	Y	Y	Y	N
Manufactures for himself	Y	Y		
Manufactures on behalf of others			Y	Y
Marketing	Y	Y	N	N
Sales & Distribution	Y	Y	N	N
RISKS	**Normal**	**Less than normal**	**Limited**	**Minimal**
Market Risk	Y	Y	N (Minimal)	N (Minimal)
Price Risk	Y	Y	N	N
Inventory Risk	Y	Y	Y	N
Capacity Risk	Y	Y	N	N
Product Liability Risk	Y	Y	N	N
Warranty Risk	Y	Y	Limited to re-work	
Technology R&D Risk	Y	N	N	N

Distribution Models

Reward belonging to the Principal

Normal Distributor and Super Distributor

- Full risk
- Buys finished goods and markets/ sells them
- Decentralised with little or no central control or consistency
- Invoice to customer in name of FFD
- Full P&L and B/S

Limited Distributor

- Limited risks
- "Flash title" to inventory (buys from Principal once sale is agreed with customer
- Invoice in name of LRD
- P&L shows sales
- No inventory on B/S

Commission Agent

- Low risks
- Makes sales on behalf of the Principal and in the name of the Principal
- Does not take title to the goods or bear any inventory related risk
- P&L shows commission
- No inventory on B/S

Local risks, functions, assets

Distribution - Functions, Assets and Risk Analysis

FAR	*Super Distributor*	*Normal Distributor*	*Limited Risk Distributor*	*Commission Agent*
FUNCTIONS				
Marketing	Extensive	Y	Minimal	Minimal
After sales services	Y	Y	Y	N
Inventory Management	Y	Y	Minimal	N
RISKS	**Normal**	**Less than normal**	**Limited**	**Minimal**
Market Risk	Y	Y	Minimal	Minimal
Price Risk	Y	N	N	N
Inventory Risk	Y	Y	Minimal	N
Product Liability Risk	Y	N	N	N
Warranty Risk	Y	Recourse available with the Principal		N

Transfer Pricing Methods

The Methods - Snapshot

Turnover (Cost of sales)	Comparable Uncontrolled Price
Gross profit (administration, Marketing, Selling and Distribution expenses)	Resale Price Method Cost Plus Method
Operating profit	TNM Method Profit Split Method
Price charged / paid or proposed	'Other' Method

Transfer Pricing Methods and Comparability

Methods	Comparability Requirements	Approach	Practical Applicability
CUP	Very High	Prices are benchmarked	Low
RPM	High	Gross margins are benchmarked	Low
CPM	High	Gross margins are benchmarked	Low
PSM	Medium	Operating margins are benchmarked	Medium
TNMM	Medium	Operating margins are benchmarked	High
Other	High	Prices charged / proposed to be charged	For selected transactions

Most Appropriate Method – General applicability

Method	Transaction Type
CUP	Loans, Royalties, Service fee, transfer of tangibles , guarantee fees
RPM	Marketing operations of finished products, where distributor does not performing significant value addition to product
CPM	Sale of finished / semi-finished goods or services
PSM	Transactions involving provision of integrated services by more than one enterprise or involving unique intangibles
TNMM	Provision of services, manufacture / distribution of finished goods and guarantee fees
Other	Purchase of second hand capital goods involving chartered engineer's certificates, buy-back of shares as per the valuation report of independent accountants

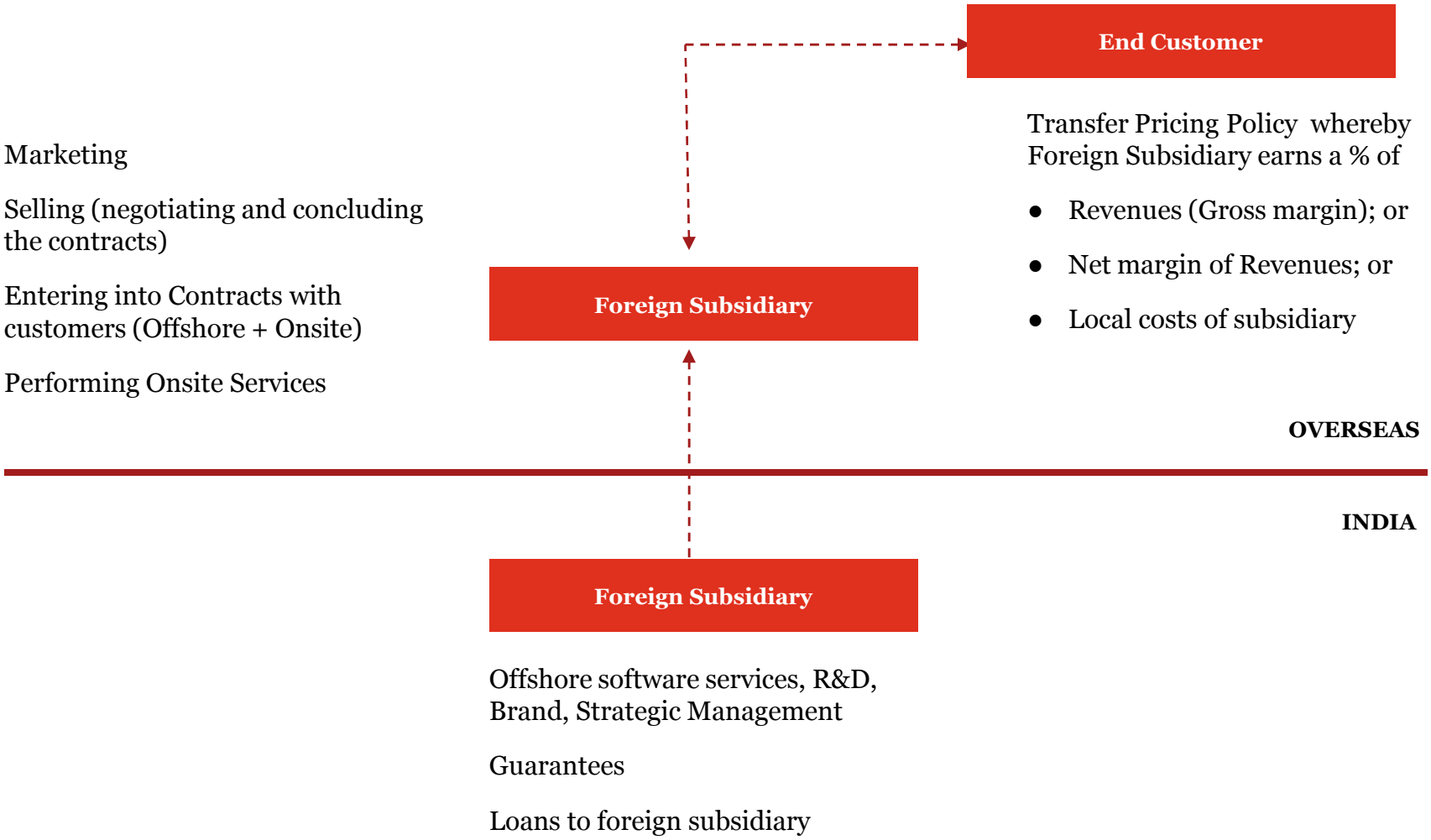
Profit Level Indicators

Method	PLI	Formula	Typically used for
RPM	Gross margin	Gross Profit/Sales	Distributor
Cost Plus	Gross cost plus margin	Gross Profit/DICOP (Direct & Indirect Cost of Production)	Manufacturer
TNMM	Return on total costs	Operating Profit/Total Costs	Manufacturer / Service provider
TNMM	Operating margin	Operating Profit/Net sales or net turnover	Manufacturer / Distributor
TNMM	ROA	Operating Profit/Operating Assets	Manufacturer
TNMM	OP/ VAE	Operating Profit/ Value Added expenses	Manufacturer who are economically processors
TNMM	ROCE	Operating Profit/ Capital Employed	Manufacturer

Industry Specific Case Studies

IT Industry
Outbound Companies

Business Model



Characterization of overseas subsidiary & Indian Parent

- **Characterisation** - Entrepreneur vs. Distributor of services vs. Marketing service provider
- **Tested Party** – Overseas subsidiary vs. Indian Parent
- **Selection of Profit Level Indicator** – Return on Sales vs. Return on Cost
- ***Relevant case laws / guidance***

  Mastek Ltd

  Ahmedabad Tribunal held that Mastek UK assumed market risk and credit risk and acted as a distributor rather than as a marketing service provider. The Tribunal, relying on the UK HMRC guidance, concluded that distributors would need to be compensated on a return on sales basis and not on a cost plus basis.

  AIA Engineering Ltd.

  Ahmedabad Tribunal held that once the issue of the AE being a distributor is resolved, the ALP has to be determined on the basis of profit on sale of goods by the taxpayer as compared to the comparable companies.

  Development Consultants Pvt. Ltd

  Kolkata Tribunal held that tested party should be the least complex entity and affirmed the AE to be the tested party as it was engaged in distribution of services. The Hon'ble Tribunal also upheld the use of foreign comparables.

Automobile – Distribution function with low value added assembly

ABC India Pvt. Ltd.

- ABC India was set up in year 2006
- Imports CBUs (completely built units), CKDs (completely knocked down) and spare parts
- Mainly engaged in the **import and resale of CBUs** of the luxury models of cars from ABC Group for resale in the Indian market
- In addition to the distribution activity, the Company also carries out **low value added assembling** (screw driver technology) **of CKDs** 2007
- Company incurred losses at the net level due to the **start-up phase and high operating costs**
- Assembly cost incurred by ABC India comprises only **5% of its total cost**

Benchmarking Approach

- For **Distribution Function**: GP/Sales margin of ABC India compared with that of independent third party distributors of cars in India
- For **Assembly Function**: An appropriate arm's length return was determined to remunerate the Company for carrying out **low value added assembly activity**
- A search was performed for **contract manufacturers**, performing manufacturing activity in the automobile industry, using OP/CE as the PLI
- Contract manufacturing search
  - Net worth > = 0
  - Operating Profit > 0
  - Manufacturing Sales/Sales > 90%
  - Royalty/ Sales = 0%
  - Raw Material Cost /Total Cost in the range of 35% - 65%

Benchmarking Approach

- Average **OP/CE** of contract manufacturers was computed in order to determine the arm's length return for the low value added activity carried out by ABC India
- The overall arm's length return for both distribution and low value added assembly activity was computed in the manner depicted in the table below:

(*Amount in INR*)

Sales of ABC India during the year (a)	9,366,790,775
Net fixed assets / CE of ABC India during the year (b)	965,507,768
Arm's Length OP/CE (c)	17.29%
Arm's length return for low value added assembly function of ABC India (d = b * c)	166,936,293
Arm's length GP/Sales (e)	7.52%
Arm's length return for distribution function of ABC India (f = a * e)	704,382,666
Total Arm's length return for ABC India (g = d + f)	871,318,959
ABC India's Gross Profit for the Year (h)	2,562,569,648
Effective arm's length GP/Sales, adjusted for assembly return (i = g/a)	9.30%
ABC India's GP/Sales for the year (j = h/a)	27.36%

Benchmarking Approach

- As can be seen from the table, ABC India earned a Gross Profit during the year, which was higher than the **combine arm's length return** for a distribution and low value added assembly function
- Contract manufacturers performing relatively higher end assembly/ manufacturing activities, as compared to ABC India. Accordingly the mean margin on 17.29% was considered on a **conservative side** for applying the same to the assembly activities of ABC India
- The Business model and characterisation of ABC India has been accepted by the TP Officer in the most recent TP Audit proceedings.

Key Takeaway

- Think uniquely / differently while formulating the appropriate TP model, that fits their business / commercial realities / peculiarities instead of strait-jacketed TP models, especially in years of losses / low profits.

Telecommunication Services

Background

- ABC India is engaged in providing internet and related network services to customers in India
- Globally, ABC Group is a recognized leader in telecom services and provides global, integrated and customized communication infrastructure solutions that enable the key business processes of its customers
- Customers contracts for integrated services on ABC Group's network spread across the globe
- In many cases the customers of ABC Group has one decision maker, the head office, which is usually located in one country and ABC Group can deal directly with the one location to complete the sales contract and invoice the customer centrally for all services in all countries

Background

- Generally, only one ABC Group entity records the revenues generated from the multinational customer
- Underlying costs of providing services are generated across the span of the ABC Group, which creates a mismatch between where the revenue is recorded and where the expenses are incurred to provide the services
- In some cases, the customers' decision-makers are spread between different countries, and require the services to be billed between more than one location, but not necessarily all the locations where the services are provided- this again results in a mismatch between where the revenues are recorded and where the services are provided
- Each of the entities in the ABC Group is reliant upon the other functions to generate global profits or losses for ABC Group, the services and investments made by each of these entities is of a non-routine nature

International transactions – Snapshot

Nature of activities/ services undertaken by ABC India
Routine support services
Unique intangible/ value added services
• Deployment of networking equipment
• Sales and marketing activities
• Liaising and coordination
• Field operations

Benchmarking Approach

- RPSM provides the most reliable method for evaluating the fees paid for services between group entities
- All Group entities are provided with a return for the support activities that each entity performs
- Three important value drivers for the Group's global telecoms business are
  - Network Operations,
  - Sales and Marketing and
  - Field Operations

Benchmarking Approach

Key Value Drivers: 1. Network Operations

- The group's reputation in the industry – due to its global network footprint
- Facilitates the provision of high quality, secure, and reliable telecoms services
- Facilitates provision of new product and service offerings
- Helps meet the demand of customers who prefer to have most or all of their telecommunications requirements fulfilled by one supplier; and
- Facilitates cost efficient transmission

Benchmarking Approach

Key Value Drivers: 2. Sales and Marketing

- Price Sensitive- very competitive
- Customers not loyal to any particular service provider- want value added services/ solution
- Maintaining and growing customer base- strategic importance

Benchmarking Approach

Key Value Drivers: 3. Field Operations

- Field operations personnel within the group are responsible for maintenance and expansion of global network and provision of high quality telecom services across the globe
- Field operations personnel are in direct contact with the customers on a regular basis- they also contribute to revenue growth by supporting the sales and marketing operation by identifying new opportunities

Benchmarking Approach

Measurement of Contribution

Driver 1: Network Operations:

- Network Depreciation
- Network Personnel cost
- Historical investment
- Foregone performance payments

Drivers 2: Sales and Marketing

- Personnel cost

Driver 3: Field Operations

- Personnel cost

Benchmarking Approach

Group Operating Profit/Loss

Less Support Activity Expenses + 8%

Residual Profit/Loss

Distributed among AEs based on
their Contribution to the Business Value Drivers

Network Operation
(*Weighted at 33%)*

Sales and Marketing Operation
(*Weighted at 33%)*

Field Operation
(*Weighted at 33%*)

Benchmarking Approach

Calculation of revenue for ABC India

Global Profit/(Loss)	(900)
Less:	
Routine retrun	100
Residual Profit/(Loss) to be split on the basis of contribution to key value drivers	(1,000)

Particulars	Global Key Value Driver Cost	India Key Value Driver Cost	India value driver as a % of Global profit/ Loss	Global Residual Profit/ (Loss)	India Residual Profit/ (Loss)
Sales & Marketing	500	2	0.40%	(333)	(1)
Network Investment	1,200	20	1.67%	(333)	(6)
Field Operations and Integration Services	1,500	3	0.20%	(333)	(1)
			Total	**(1,000)**	**(8)**

Profit/ (Loss) split based on key value drivers	Global	India
Sales & Marketing	(333)	(1)
Network Investment	(333)	(6)
Field Operations and Integration Services	(333)	(1)
Total	**(1,000)**	**(8)**

Routine Cost for ABC India	12
Mark up of 8% on routine costs	**1**
Net Profit/ Loss for ABC India	**(7)**

Thank You