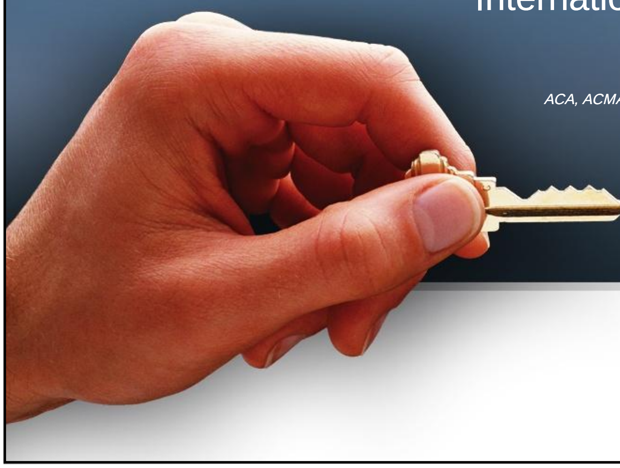
International Financial Accounting and Policy



International Transfer Pricing

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Transfer Pricing Background

- Ø Transfer pricing is the determination of price on the exchange of goods or services between related parties.
- Ø These transfers are also referred to as intercompany transactions.
- Ø Upstream transfers go from subsidiary to parent, downstream transfers are from parent to subsidiary.
- Ø Transfers also occurs between different subsidiaries of the same parent.
- Ø A significant proportion of international transactions are intercompany transfers.

Decentralization and Goal Congruence

- Decentralized companies are organized by division and division managers have significant authority.
- It also permits local decision making which provides more responsibility for division managers.
- An agency problem can occur since division managers make decisions in their self-interest. - The manager’s self-interest can vary with the best interests of the company.
- An effective accounting system can alleviate this agency problem by providing incentives to division managers to act in the interests of the organization.
- This is referred to as goal congruence. - These concepts are relevant to both multinational and purely domestic companies.

Performance Evaluation and Transfer Pricing

- Transfer prices directly affect the profits of the divisions involved in an intercompany transaction.
- Some performance evaluation systems are based on divisional profits.
- The effectiveness of these performance evaluation systems is influenced by the fairness of transfer prices.
- The effectiveness of performance evaluation systems affects the satisfaction of managers.

Cost Minimization and Transfer Pricing

- Profit maximization and, by extension, cost minimization are important corporate objectives.
- Manipulating transfer prices between countries is one way for multinational enterprises to achieve cost minimization.
- This is referred to as discretionary transfer pricing.
- The most common approach is to minimize costs by shifting profits to lower tax rate jurisdictions.

Government Reactions

- Governments are aware of risk that multinationals will use transfer pricing to avoid paying income and other taxes.
- Most governments publish guidelines regarding acceptable transfer pricing.
- The guidelines typically use the notion of an arm's-length price.
- Arm's-length price is the price that would be agreed upon by unrelated parties.

Sale of Tangible Property

- Comparable uncontrolled price method.
- Resale price method.
- Cost-plus method.
- Comparable profits method.
- Profit split method.

Comparable uncontrolled price method

- Widely considered the most reliable measure when a comparable uncontrolled transaction exists.
- Transfer price is determined based on reference to the company's sales of the same product to an unrelated buyer.
- Reference to transactions between two unrelated parties for the same product are acceptable.
- If an uncontrolled transaction is not exactly comparable, an adjustment is allowable.

Resale price method

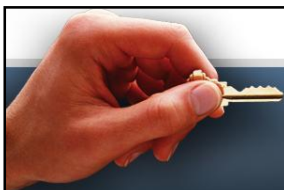
- Ø Generally used when the affiliate is a sales subsidiary and simply distributes finished goods.
- Ø Transfer price is determined by deducting gross profit from the price charged by the sales subsidiary.
- Ø Gross profit is determined by reference to uncontrolled parties.
- Ø The most important factor in choosing this method is the similarity in function of the affiliated sales subsidiary and the uncontrolled reference company

Cost-plus method

- Ø Most appropriate when comparable uncontrolled transactions don't exist and sales subsidiary does more than simply distribute finished goods.
- Ø Transfer price is determined buy adding gross profit to the cost of production.
- Ø Gross profit is determined by reference to uncontrolled parties.
- Ø Factors influencing the comparability of uncontrolled transactions include: complexity of manufacturing process, procurement activities, and testing functions.

Comparable profits method

- Underlying principle is that similar companies should earn similar returns over a period of time.
- One of the two related parties in the transactions is chosen for examination.
- Transfer price is determined via reference to an objective measure of profit of an uncontrolled company involved in comparable transactions.
- Typical measures of profit include: ratio of operating income to operating assets, and operating income to sales.



Profit split method

- Treats the two related parties as one economic unit.
- Profit from the eventual sale to an uncontrolled party is allocated between the related parties.
- Allocation is based on relative contribution of each party.
- Contribution is determined by functions performed, risk assumed, and resources employed.

Sale of Tangible Property - Summary

- Any particular transfer pricing method used can result in a range of transfer prices.
- Companies can use discretion to set prices within the range in order to achieve cost minimization objectives.
- Companies can also use discretion in determining the “best” method.