BANGLADESH COST ACCOUNTING STANDARDS

BCAS - 16

Transfer Pricing

BCAS 16: Transfer Pricing

16.1 Introduction

Transfer pricing mainly deals with the procedure and method of setting prices of the products (goods or services) while transferred from one segment to another segment in a decentralized setting. In modern management accounting system organizations are decentralized (and becoming decentralized) where decision making responsibility has been delegated to the responsibility centers. When the decision making responsibility is delegated or decentralized to responsibility centers, transfer pricing becomes a very important tool and thus highly used to measure and evaluate the performance of those responsibility centers; to motivate the managers of the responsibility centers so that they make intra-responsibility center decisions that are in the best interest of overall organizations avoiding sub-optimal decisions. Therefore, a standard practices of setting transfer prices is required which will ensure accuracy and appropriateness of the transfer prices set and, hence, ensure to achieve the objectives of transfer pricing, as mentioned above, more accurately and appropriately.

16.2 Objectives

The primary purpose of the standard is to prescribe the ways and procedures of setting transfer prices of goods or services. Specific objectives of the standard can be pointed as below:

a) The standard tries to standardize the methods of setting transfer prices for the benefits of organizations and practitioners as well.
b) The standard facilitates management in evaluating financial performance of responsibility centers, motivating responsibility center to take decisions in the best interest of the organization as a whole, facilitating inventory costing of the transferee etc.
c) The standard helps fair practice in setting arm's length transfer prices in international transactions, and, hence, protects government interest.

16.3 Scope

16.3.1 This standard shall be applied in setting transfer prices of goods or services that are transferred intra-company, between associated enterprises inside border, and between associated enterprises across the border.

16.3.2 More specifically, the standard shall be applied in cost and management accounting practices relating to goods or services that are transferred -

a) between processes, departments, divisions, segments, units etc. of an individual company, between associated enterprises under the local group inside the border (domestic transfer pricing)
b) between associated enterprises under the multinational groups across the border (international transfer pricing)

16.3.3 This standard may be followed by companies and other business or non-business organizations where cost and management accounting is in practice either as a statutory obligation or to support management decision making process.

16.4 Key Features

The key features of this standard are pointed below -

- a) Present mechanism of setting transfer pricing in different situations;
- b) Address the impact of sub-optimal decision on ultimate corporate goals;
- c) Bring management accounting application of transfer pricing;
- d) Protect the interest of respective government; and
- e) Establish fair practices in pricing to resolve any potential conflicts between transferring unit and transferred unit.

16.5 Definitions

The following terms are used in the standard with the meanings specified:

16.5.1 **Transfer price:** A transfer price is the price charged when one segment/ division/ unit of a company transfers goods or services to another segment/ division/ unit of the same company/ group.

16.5.2 **Responsibility centers:** a responsibility center is any part of an organization whose manager has control over cost, revenue or investment of funds. Cost centers, profit centers, and investment centers all are known as responsibility centers.

16.5.3 **Market price:** It is the price charged for an item in an open market.

16.5.4 **Highly competitive market:** Highly competitive market implies the condition that the producing division can sell as much of the product as it wishes to outside customers, and the purchasing division can purchase or acquire as much as it wishes from outside supplier without affecting the price.

16.5.5 **Intermediate product:** An intermediate product is a product that might require further processing before it is saleable to the ultimate consumer. This further processing might be done by the producer or by another processor. The further processing of the intermediate product might also be done by another division/ segment of the same company.

16.5.6 **Associated enterprise:** Associated enterprise, in relation to another enterprise, means an enterprise which, at any time during the income year, has the following relationship with the other enterprise -

(a) one enterprise participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or
(b) the same person or persons participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital, of both enterprises; or
(c) one enterprise holds, directly or indirectly, shares carrying more than twenty five percent of the voting power in the other enterprise; or
(d) the same person or persons controls shares carrying more than twenty five percent of the voting power in both enterprises; or
(e) the cumulative amount of borrowings of one enterprise from the other enterprise constitutes more than fifty percent of the book value of the total assets of that other enterprise; or
(f) the cumulative amount of guarantees provided by one enterprise in favour of the other enterprise constitutes more than ten percent of the book value of the total borrowings of the other enterprise; or

(g) more than half of the board of directors or members of the governing board of one enterprise are appointed by the other enterprise; or
(h) any executive director or executive member of the governing board of one enterprise is appointed by, or is in common with the other enterprise; or
(i) the same person or persons appoint more than half of the board of directors or members in both enterprises; or
(j) the same person or persons appoint any executive director or executive member in both enterprises; or
(k) one enterprise has the practical ability to control the decision of the other enterprise; or
(l) the two enterprises are bonded by such relationship of mutual interest as may be prescribed. [Sec 107A(2), ITO 1984]

16.5.7 **Arm's Length Price:** It is the price which is applied in a transaction between parties in uncontrolled conditions.

16.6 Standards

16.6.1 **Transfer pricing should be practiced ethically keeping the interests of all the related parties and at the same time it should not compromise goal congruence.**

16.6.2 **There is no single transfer pricing method or policy or transfer price that will be best suited in all situations. Rather the method of transfer price to be used depends on the particular situation and the organization's objectives in using transfer pricing. The transfer pricing method to be chosen should reflect a careful consideration of how the method chosen has impact on the motivation of the managers of the responsibility centers as well as the interest of the organization as a whole. For pricing transfers between associated enterprises under the same group, careful consideration should be given to compliance requirements of Income Tax Ordinance 1984 and other applicable regulatory requirements.**

16.6.3 **There are four widely used approaches to set transfer prices as follows:**

a) Market price;
b) Cost based price
- **i) Variable (flexible) cost,**
- **ii) Full (absorption) cost,**
- **iii) Standard cost,**
- **iv) Hybrid cost;**

c) Administered price; and
d) Negotiated price.

16.6.4 **Where a highly competitive market exists for an intermediate product, market price should be used as the transfer price.**

16.6.5 In the highly competitive market environment market provides an objective valuation of the intermediate product and that price (market price) should be used to price transfers and guide decisions within firm. If the purchasing division cannot make a long run profit at the outside market price (assuming market price is a reasonable approximation of the long-run price and not simply a short-run distress price), then the company is better off to not produce the product internally and to go to external market for its supply. Similarly, if the purchasing division cannot make a long-run profit when it must acquire the product at the external market price, the division should cease acquiring and processing this product and should allow the producing division to sell its output to the external market. With a highly competitive market for the intermediate product, the market price provides an excellent basis for allowing the decisions of the producing and purchasing divisions to be independent of each other.

16.6.6 Some modifications to pure market price rule facilitate its use in practice. The company will usually benefit if the transaction occurs internally rather than having a producing division sell a certain amount externally while the purchasing division is acquiring the same amount from its own outside suppliers. Internal transfer, in comparing with external transfers, may have some savings on expenses e.g. savings on selling, marketing, distribution expense etc. to the selling division and savings on ordering, collection expenses etc. to the buying division. In this case internal transfer may be priced at market price ± certain adjustments. The adjustments may be to deduct the savings on expenses regarding selling, delivery, service, warranty etc. associated with external sales comparing with internal transfer. Whereas, some additional cost may need to be incurred by selling division for internal transfer e.g. costs incurred to product quality or product confidentiality requirements as required by purchasing division which are not normally required for external sales. Theses cost may be adjusted with/added to the market price.

16.6.7 When the selling division has idle capacity, market price may not be the best choice for transfer pricing. Market price may be adjusted for idle capacity which will set the transfer price less than the market price.

16.6.8 **Where there is no market price available for the intermediate product, cost-based prices are appropriate to use for pricing transfers.**

16.6.9 The cost-based transfer price that uses variable (flexible) costs will include all the variable costs that are associated with manufacturing and delivering/ transferring the intermediate product. The ground on which variable cost may be used as transfer price is responding to periodic change in demand or factor prices. If that need is absent, variable cost transfer pricing has no apparent justifications and is not recommended to use.

16.6.10 The cost-based transfer price that uses full (absorption) costs will include both variable and fixed costs associated with manufacturing and delivering/ transferring the intermediate product. The justification for using the full cost transfer pricing is that it is believed that full cost is the proxy of long-run marginal costs and hence transferring intermediate goods at full costs will be best for the organizations in the long-run. However, full costs suffer from many limitations e.g. i) it may lead to suboptimal decisions in the situation where selling division has idle capacity; ii) the selling division will never show a profit in any internal transfer, which may de-motivate the selling division; iii) it may not provide incentives to selling division to control costs as the actual costs of one division are simply passed on to the next; iv) it may be miss-cost transfers if the capacity related costs are allocated improperly without considering the cause-effect relationship; v) it may undercost transfers as the full costs usually don't include the allowance for cost of capital etc.

16.6.11 Transfer may be made using standard costs of intermediate product instead of actual costs. The ground for using standard costs is that it will provide incentive to selling division to control costs which was absent in transferring at full costs.

16.6.12 A cost-based transfer price that uses hybrid cost approach will include either of variable costs or full costs or standard costs plus an allowance for cost of capital (i.e. a mark up to recover invested capital).

16.6.13 **Where transactions occur frequently and where it is felt that market price will create unreasonable results, administered transfer prices may be set in organizations, and in this case an administrator or policy maker sets the transfer price.**

16.6.14 Administered transfer price often reflect non-economic objectives, and are practical way of avoiding transfer price confrontations. However, it may violate the spirit of accountability which was the basic objective of creating responsibility centers in first place.

16.6.15 **Where an outside market exists for the intermediate product but is not perfectly competitive and a small number of different products are transferred, a negotiated transfer price will be best suited, where the buying and selling division will negotiate and set the transfer price.**

16.6.16 There will be a range of acceptable transfer prices - range of transfer prices within which the profits of both the participating divisions will increase. In the range of acceptable transfer prices, the lower limit will be determined by the situation of selling division and upper limit will be determined by the situation of buying division. Actual transfer price agreed to by the participating divisions may fall anywhere between these two limits. And the sharing between the participators of difference between upper limit and lower limit will be determined by the bargaining power of the divisions.

Lower limit of transfer prices (seller division's perspective) can be calculated as follows:

$$\text{Transfer price} \geq \text{variable cost per unit of product} + \frac{\text{Total contribution margin on lost sales}}{\text{Number of units transferred}}$$

Upper limit of transfer price (buyer division's perspective) can be calculated as follows:

$$\text{Transfer price} \leq \text{cost of buying from outsider supplier}$$

16.6.17 The justifications for negotiated transfer prices are firstly, it preserves the autonomy of the divisions and is consistent with the spirit of creating responsibility centers or decentralization of organization; and secondly, the managers of the participating divisions are likely to have much better information about potential costs and benefits regarding the transfer than others in the company. However, negotiated transfer price, and their resulting organizational unit profits, may reflect the negotiating ability rather than underlying financial realities of the organizational units.

16.6.18 **International transfer pricing has two dimensions - internal and external. For internal dimension of international transfer pricing considerations may be given to factors like minimizing foreign exchange risks; increasing competitive position of the foreign subsidiary; and improving relations with foreign governments. For external dimension of international transfer pricing consideration should be given to the regulatory requirement and its tax implications and, in this case, Organization for Economic Cooperation and Development (OECD) transfer pricing guidelines for multinational enterprises and tax administration should be followed while ensuring that local regulations regarding transfer pricing between related parities of multinational enterprises are not violated.**

16.6.19 Usually in international transfer pricing considerations given to minimizing global taxes, duties and tariffs; minimizing foreign exchange risks; increasing competitive position of the foreign subsidiary; and improving relations with foreign governments. Motivational factors, divisional autonomy etc. which are the basic objectives of domestic transfer pricing become secondary in international transfer pricing. Tax authorities understand this incentive and have taken initiatives, enacting rules & regulations regarding transfer pricing, to moderate corporate behavior so that multinational companies cannot set arbitrary transfer price and avoid local taxes. In Bangladesh a chapter on transfer pricing has been added to The Income Tax Ordinance 1984 (Chapter-XIA: Transfer Pricing). Rules regarding transfer pricing as per the ITO of Bangladesh are also in conformity with OECD guidelines, like most other countries.

16.6.20 The OECD guidelines emphasize arm's-length principle in case of setting transfer prices among associated enterprises. Under arm's length principle transfer price should equal a price determined by reference the interaction of unrelated firms in the market place. But it is often difficult to obtain sufficient information application of arm's length principle in practice. Therefore, focus is given on best practice in determining the equivalent of market price for inter-company transactions within multinational groups.

16.6.21 The OECD transfer pricing guidelines for multinational enterprises divide transfer pricing into two main methods- traditional transaction methods and transactional profit methods- for determining arm's length price. The 'traditional transaction methods' includes comparable uncontrolled price (CUP), cost-plus, and resale price method. The 'transactional profit methods' include transactional net margin methods and transactional profit split methods. The OECD guidelines require most appropriate method should be selected taking into strengths and weaknesses of OECD recognized methods considering several elements, including availability of reliable information. The OECD guidelines state that if the CUP method and another transferring method can be applied equally reliable manner, the CUP method should be preferred.

16.6.22 Comparable uncontrolled price (CUP) method offers the most direct way of determining an arm's length price. It compares the price charged for goods or services transferred in a controlled transaction to the price charged for goods or services transferred in a comparable uncontrolled transaction. If the price so identified differs from the price of the international transaction, the differential will be calculated first, with which (differential amount) the price of the international transaction will then be adjusted to reflect the arm's length price.

16.6.23 Under resale price method an arm's length price is determined by deducting an appropriate discount for the activities of reseller from the actual resale price. The appropriate discount is the gross margin, expressed as percentage of net sales, earned by reseller on the sale of goods that is both purchased and resold in an uncontrolled transaction in the relevant market.

16.6.24 Under cost-plus method arm's length price is determined by adding an appropriate mark-up on the cost of production. The appropriate mark up is the percentage earned by a manufacturer on unrelated party sales that are the same or very similar to the inter-company transaction. The cost base to be used for mark-up will also be determined on the same or very similar basis as determined by the unrelated comparable company.

16.6.25 Under profit split method transfer pricing is established by dividing the profit of a multinational enterprise in a way that would be expected of independent enterprise in a joint-venture relationship. Profit split would be done either of the ways- a) each of the associated enterprises will allocated a basic return based on the basic functions (manufacturing, distribution, providing services etc) they perform as to be determined by independent enterprise in similar transaction. This basic return will not account for use of any unique and valuable assets by the associated enterprises. The residual profit (which may be attributed to such unique and valuable assets), to be calculated by deducting the sum of basic returns allocated to associated enterprises from the combined profit, is then to be apportioned to the associated enterprise based on their relative contribution and taking into account how independent enterprises in similar circumstances would have divided such residual profit; OR b) basic return will not be allocated to the associated enterprises; the combined profit will be divided among the associated enterprises based on the relative contribution of each of the associated enterprises to that profit. It might be appropriate to use this method for highly integrated operations for which a one sided method would not be appropriate. It may also be most appropriate method in cases where both parties to the transaction make unique and valuable contributions to the transaction.

16.6.26 Transaction net margin method (TNMM) compares the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a company makes from a controlled transaction with the net profit margin relative to the same base achieved in comparable uncontrolled transactions. Appropriate adjustment is made to the net profit margin to consider the difference in nature of transactions and that adjusted net profit is applied to be base to arrive at arm's length price.

16.6.27 Any other method can be used for setting up transfer price in international transactions, where it can be demonstrated that- i) none of the above five methods can be reasonably applied to determine arm's length price for the international transactions; and ii) such other method yields a result consistent with arm's length price.

16.7 Recording and Reporting

16.7.1 Companies are required to record and report the following information relating to transfer pricing issues:

- a) Product cost related information like variable costs, fixed costs, manufacturing costs, non-manufacturing costs etc.
- b) Capacity related information like installed capacity, idle capacity etc.
- c) Regular pricing mechanism like pricing methods, mark-up, margin etc.
- d) Any other particular deems to be important.

16.7.2 Organizations should have a formal appraisal system of setting transfer prices, teams to negotiate the price and other infrastructure relating to transfer pricing.

16.7.3 Organizations should have its own mechanism of preparing transfer pricing report containing all relevant information to the satisfaction of regulators.

16.7.4 All the calculations and documents should be preserved by a designated person or department so that such documents could be produced before competent authority on demand.

16.7.5 There should be a mechanism of reporting transfer pricing related information within the organization as required.

16.8 Effective Date

This standard will be effective from January 1, 2017 onwards.

Appendix 16A

This appendix shows the application of transfer pricing methods based on the information as given in the Table below and scenarios as mentioned thereafter in the relevant sections.

	Case - A	Case - B
Division X		
Capacity in units	100,000	100,000
Number of units being sold to outside customer	100,000	80,000
Market price per unit (in BDT)	50	50
Variable cost per unit (in BDT)	30	30
Fixed costs per unit (based on capacity) (in BDT)	8	8
Division Y		
Number of units needed for production	20,000	20,000

Case-A

In Case-A above, assuming a highly competitive market condition, there is no idle capacity. If the transfer is taken place at any price below the current market price (BDT 50/unit) Division X (the transferring division) will lose contribution by the amount less than current market price multiplied by the no. of units to be transferred. So, Division X will not agree on transfer. On the other hand if Division Y wants to purchase it from market it will have to pay the current **market price,** so, logically, Y will not disagree to take the transfer at BDT 50/unit from X. In this situation the optimum transfer price will be market price, at which both the transferring and transferee division should agree.

In above scenario assuming further that there is selling and distribution expense @ BDT 2 per unit for outside sale. In this scenario X could save BDT 2/unit of if the transfer is taken place. So, there could be some modification to pure market price rule. Here, if the transfer is taken at BDT 48/ unit (i.e. BDT 50 - BDT 2), X will not lose any contribution for the units transferred because loss in sales revenue will be compensated by the savings in selling and distribution expenses. From the company's point of view as whole BDT 2/unit will be saved on no. of units transferred. Therefore, transfer should take place rather than selling outside. However, it may be negotiated between two departments about the share of BDT 2 saved per unit.

Case-B

In Case-B above it is seen Division X has idle capacity of 20,000 units and demand from Division Y is 20,000 units also. Therefore, if transfer is not taken place X will not gain anything. As there will be no additional fixed cost for production up to 20,000 units, X will be benefited from transfer at any price above variable costs, being there is no loss of contribution from existing sales reduction. Therefore, the minimum transfer price from Division X's point of view will be as follows:

$$= \text{variable cost per unit of product} + \frac{\text{Number of units transferred}}{\text{Total contribution margin on lost sales}}$$

$$= \text{Tk. } 30 + [(0 * 20{,}000)/20{,}000]$$
$$= \text{Tk. } 30$$

Division Y will not agree on any price more than market price (BDT 50) and any price below market price will be savings in purchase cost to it. Therefore, negotiated pricing methods will be applicable here and the range of prices will be BDT 30 - BDT 50 within which the two participating divisions can negotiate so that both divisions get a rational share of benefit.

Appendix 16B

This appendix illustrates OECD Principles of transfer pricing which is very much closed to transfer pricing methods as required through Income Tax Ordinance, 1984.

a) Comparable Uncontrolled Price Method (CUPM)

ABC US, a US company exports printers to its subsidiary in Bangladesh ABC BD for resale. ABC US also exports printers other companies in Bangladesh, say XYZ Ltd, an unrelated party. The price charged by ABC US to ABC BD $150 (controlled transaction) and whereas the price charged to XYZ Ltd. is $120 per printer (comparable uncontrolled transaction).

As per the CUPM the arm's length transfer price would be as follows:

Price of controlled international transaction	$120
Price of comparable uncontrolled transaction	$150
Differential	-$30

Therefore, the arm's length price of the international transaction would be $120 (i.e. $150 - $30)

b) Resale Price Method (RPM)

XYZ BD is a distributor of refrigerators supplied by its UK parent XYZ UK. The end price to the consumers (i.e. retail price) is BDT 60,000 per unit. Rahim Ltd. is a local independent distributor in Bangladesh which performs the similar functions (importing refrigerators from UK and other countries and distribute them locally in Bangladesh) and gross margin of Rahim Ltd. is on an average 15% on its sales price.

As per the RPM the arm's length transfer price would be as follows:

Retail price in Bangladesh	BDT 60,000
Less: Gross margin of an uncontrolled similar transaction @ 15%	BDT 9,000
Transfer price using RPM	BDT 51,000

c) Cost Plus Method (CPM)

A Pharma (BD) is a local manufacture of drug item 'insulin' for its overseas associated company A Pharma (India). Both A Pharma (BD) and A Pharma (India) belong to the global group A Pharma Plc. in UK. There is an agreement between A Pharma (BD) and A Pharma (India) under which A Pharma (India) provides technical know-how for manufacturing and A Pharma (BD) supplies the output to A Pharma (India) as a contract manufacturer.

Analyzing the cost statements it is found A Pharma (BD) incurs cost BDT 1,000 to manufacture one unit of 'insulin'. An unrelated pharmaceutical company in Bangladesh (X Pharma Ltd.) manufactures a different drug item as contract manufacture for many other international companies. The company may be identified as a potential comparable company for the transaction. X Pharma Ltd. charges 25% mark-up on average for the contract manufacturing services to those international companies.

As per CPM arm's length transfer price of the international transaction would be as follows:

Cost incurred by A Pharma (BD) per unit	BDT 1,000
Add: Mark-up by comparable uncontrolled company for the similar transaction @ 25%	BDT 250
Transfer price using CPM	BDT 1,250

d) Profit Split Method (PSM)

Company A designs and manufactures an electronic component and transfer the same to Company B, a related company. Company B designs and manufactures rest of the component and transfers to Company C, an unrelated company, for marketing the same. Component transferred from "A" to "B" reflects the innovative technological advancement enjoyed by A in the market (and hence value for intangibles i.e. royalty). Assuming reliable comparable uncontrolled price is not available and hence CUP method cannot be used for determining arm's length transfer price.

Profit & loss of A and B before considering the arm's length transfer price of intangibles:

		A		B
Sales		5,000		10,000
Purchase		(1,000)		(5,000)
Manufacturing cost		(1,500)		(2,000)
Gross Profit		2,500		3,000
R&D	(1,500)		(1,000)	
Operating Expense	(1,000)	(2,500)	(1,000)	(2,000)
Net Profit		Nil		1,000

As per PSM the following steps are to be followed to determine the arm's length transfer price of the intangibles:

Calculation of total residual profit

It is established that third party comparable manufactures without innovative intangible property earn a return (excluding purchase) of 10%

Routine manufacturing profits/ basic returns of A and B will be determined as follows:

Routine return on costs attributed to A: 1500 X 10% = 150
Routine return on costs attributed to B: 2000 X 10% = 200

Total Residual profit = Combined net profit - basic returns of A and B
= 1000 - 150 - 200
= 650

Allocation of residual profit

It can reliably be estimated that respective R&D costs reflects the relative contribution to technological advancement/ intangibles. Therefore, residual profits can be split based on their share of total R&D costs as follows:

A's share of residual profit: 650 X [1500/ (1500+1000)] = 390
B's share of residual profit: 650 X [1000/ (1500+1000)] = 260

Calculation of split profit

Split profit = basic return + allocated residual profit
A's profit split = 150 + 390 = 540
B's profit split = 200 + 260 = 460

Therefore, the arm's length transfer price would be 5540 (i.e. 5000 + 540), sales price of A and purchase price of B.

e) Transactional Net Margin Method (TNMM)

Bangladesh Motors Ltd. (BML) is a Bangladeshi manufacturer of private car parts. All of BML's car parts are exported to China Motors Ltd., a motor company in China that sells car parts manufactured by BML. CUP method is not applicable because market price of comparable uncontrolled transaction is not available. However, a company has been found out, A Motorcycle Ltd., which manufactures motorcycle parts and exports globally. Financial statement of A Motorcycles Ltd. shows that net profit margin is 10%.

As per TNMM the transfer price of international transaction would be as follows:

BML's cost of goods sold per unit	BDT	30,000
BML's operating expenses	BDT	10,000
Total costs	BDT	40,000
Add: net profit margin @ 10%	BDT	4,000
Transfer price using TNMM	BDT	44,000