



Function, Asset and Risk Analysis  
Mumbai

**Ms. Vaishali Mane**  
Director,  
Transfer Pricing Services  
Grant Thornton India LLP

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# AGENDA

Function, Assets and Risk Analysis

Tested Party Concept

Key Takeaways



**Function, Assets and Risk Analysis**

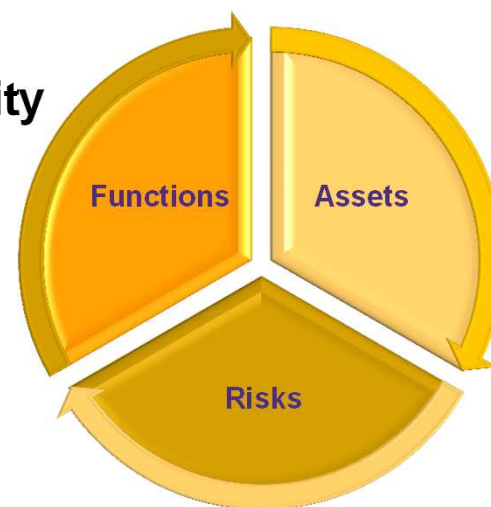
**Tested Party**

**Key Takeaways**

# Function, Assets and Risk (FAR) Analysis

## What is FAR?

- FAR analysis - exercise to determine and document **significant economic activities** performed by the enterprise and its AEs in an International Transaction
- The allocation of these activities between those entities involved in the transaction so each entity can be fully **characterised**
- **Price charged** in any transaction reflects the functions performed (taking into account the risks assumed and assets used)
- FAR analysis essential to determine **comparability**
- Functional analysis identifies and compares
  - Economically significant activities
  - Assets used
  - Risks assumed



# Function, Assets and Risk (FAR) Analysis

## Purpose of FAR

- **Gathering and organizing facts** needed to analyze intercompany prices
- To identify an **appropriate level of profit** that related parties should earn with respect to intercompany transactions under review
- To identify **effects** of functions, risks and assets on its profitability
- To determine the **economic characterization** of the entities in the international transaction
- To determine the **most appropriate method** for benchmarking the international transaction
- To identify any **uncontrolled transaction** involving one of the controlled parties

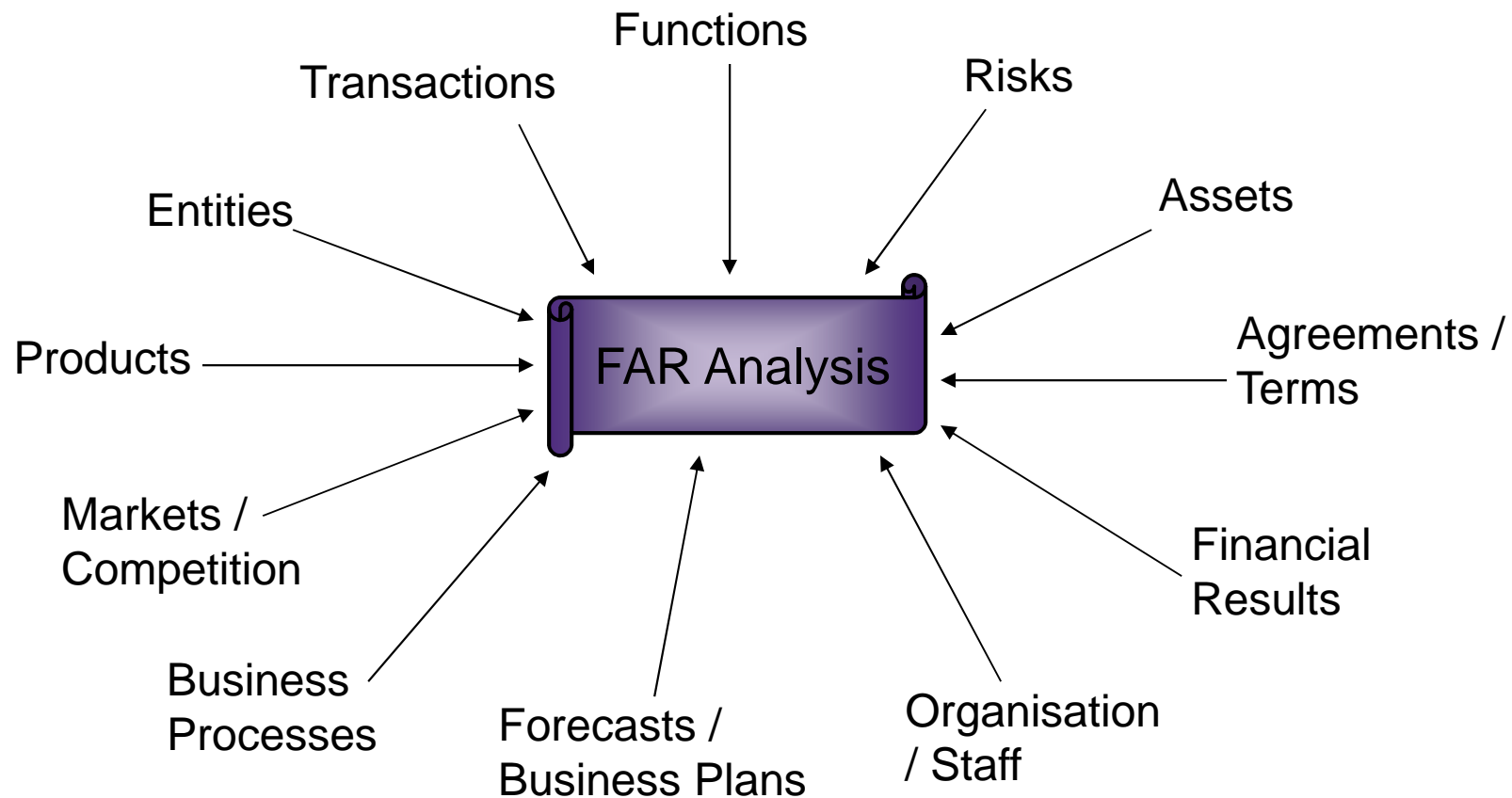
# Why do a functional analysis?

- The **arm's length principle** is based on comparability:

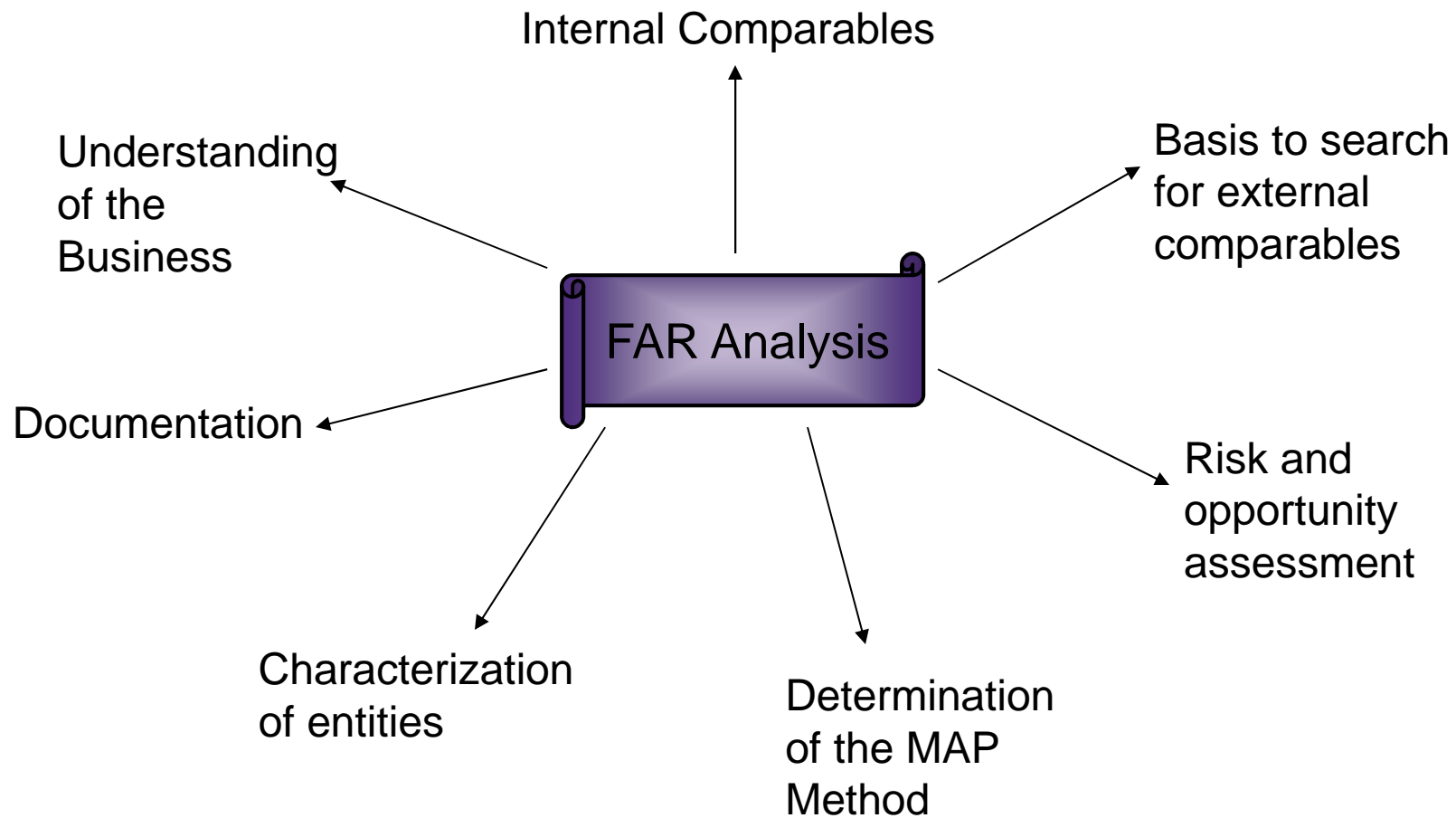
*“[When] conditions are made or imposed between ... two [associated] enterprises in their commercial or financial relations which differ from those which would be made between **independent** enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be **included in the profits of that enterprise and taxed accordingly.**”\**

\*Paragraph 1 of Article 9 of the OECD Model Tax Convention

# What goes into a Functional Analysis?



# What comes out of Functional Analysis?





# Components of FAR Analysis

- Functions performed
  - **Activities** carried out by each of the parties to the transaction
  - Focus should be on identification of **critical functions** which add value to the international transactions
  - Principal functions performed by the entities in a controlled transaction are **compared** with the functions performed in uncontrolled transactions



# Components of FAR Analysis

- Assets employed
  - The **type** of assets and their **nature** needs to be understood
  - Helps in determination of their **contribution** to the business process / economic activity
  - Facilitates understanding of respective **roles** played by the entities participating in the International transaction
  - Knowledge of assets owned and employed by the entities facilitates determination of the **profit margin** to be earned by them

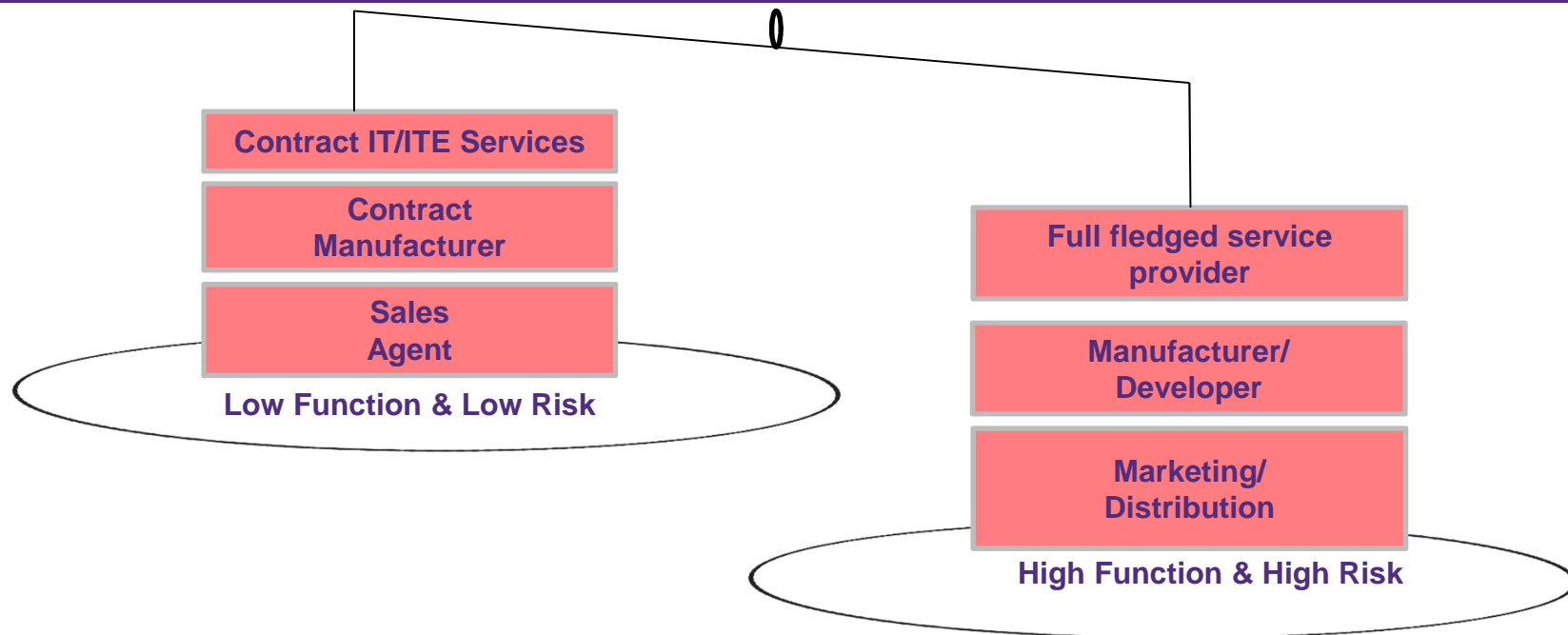
# Components of FAR Analysis

- Risks Assumed
  - Probable **variability** of future outcomes or returns
  - As the risk increases, the expected return should **increase** as well
  - The potential risks are **company and industry specific**
  - **Only important risks** should be described and quantified
  - Important to **distinguish** between which entity bears risks as per legal terms and which one bears as per the economic substance of the transaction

# Components of FAR Analysis

Functions	Assets	Risks
<ul style="list-style-type: none"><li>– Manufacturing / Processing</li><li>– Research &amp; Development</li><li>– Quality control</li><li>– Advertising / Marketing</li><li>– Sales</li><li>– Ordering and distribution</li><li>– Invoicing and collection</li><li>– Inventory</li><li>– Service, Warranty and Spare Parts</li><li>– Administrative, Financial and Legal Matters</li></ul>	<ul style="list-style-type: none"><li>- Tangible Assets (e.g Building, Plant &amp; Machinery, etc)</li><li>- Intangible Assets (e.g Patents, Trade Marks, Copyrights etc)</li></ul>	<ul style="list-style-type: none"><li>– Market risk</li><li>– Product liability risk</li><li>– Inventory risk</li><li>– Technology risk</li><li>– Research and development risk</li><li>– Credit risk</li><li>– Foreign exchange risk</li><li>– Manpower risk</li></ul>

# Importance of FAR Analysis



- Comprehensive FAR leads to in-depth understanding of the business and related commercial considerations
- Allows correct characterization of the business
- Helps setting up of an appropriate pricing model for inter company transactions
- Robust FAR analysis - foundation of a sound economic analysis

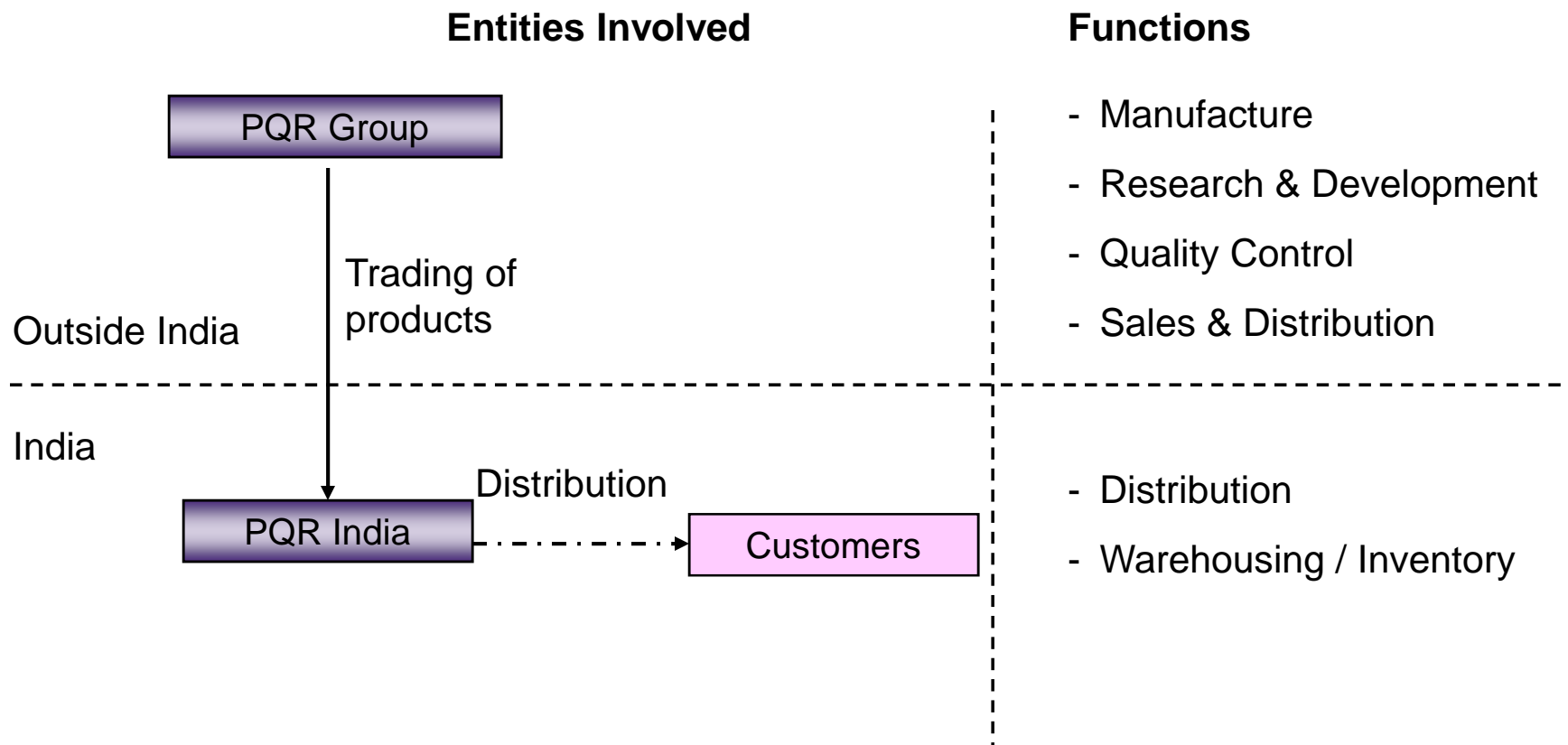
# Trading Industry

## Facts

- PQR Group, USA develops, manufactures and markets cancer related products
- PQR India is engaged in the business of import and resale of these products in India

# Trading Industry

## Function



# Trading Industry

## Assets

### Assets Employed

Type of Assets	PQR India	PQR Group
Employees	Yes	Yes
Property, Plant & Equipment	Yes	Yes
Intangible such as Trade Licenses, Know-How etc	No	Yes



# Trading Industry

## Risk

### Risk Assumed

Type of Risk	PQR India	PQR Group
Product Development Risk	No	Yes
Market Risk	Yes (Limited)	Yes
Manpower Risk	Yes	Yes
Credit & Collection Risk	Yes	Yes
General business Risk	Yes (Limited)	Yes
Foreign Exchange Risk	Yes	No

### Vital Consideration

Accordingly, PQR USA should be characterised as the 'Entrepreneur' and WDV India as 'Limited Risk distributor'

# Service Industry

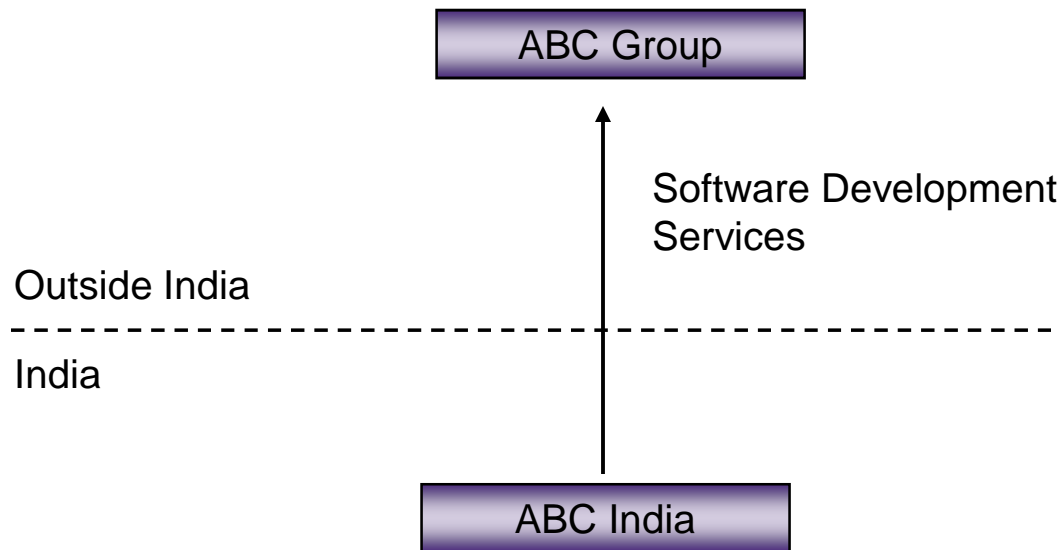
## Facts

- ABC India is a software development company. Engaged in the development of IT solutions and software products
- ABC India provides software development and related services to ABC Group
- ABC India is remunerated by ABC Group on **full cost plus mark up** basis
- All the IPRs developed and owned by ABC Group

# Service Industry

## Functions

### Entities Involved



### Functions

- Contracting, Billing & Collection
  - Services Delivery
  - Development of new products
  - Credit, Market, Service Liability Risk
- 
- Development of software
  - No Credit Risk
  - Limited Manpower Risk

# Service Industry

## Assets

### Assets Employed

Type of Assets	ABC India	ABC Group
Employees	Yes	Yes
Property, Plant & Equipment	Yes (Limited)	Yes
Intangible such as Trade Licenses, Know-How etc	No	Yes

# Service Industry

## Risks

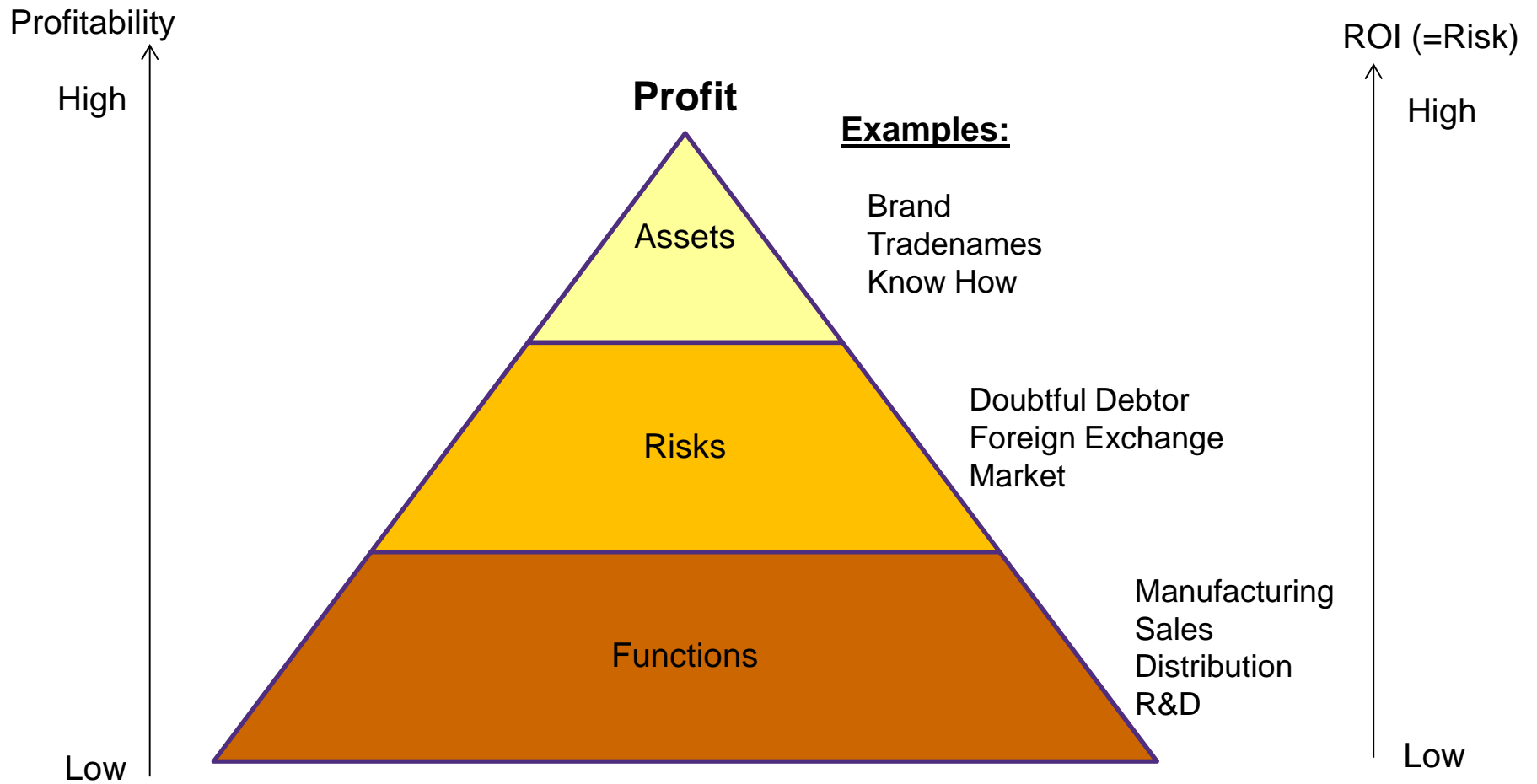
### Risk Assumed

Type of Risk	ABC India	ABC Group
Entrepreneur Risk	No	Yes
Market Risk	No	Yes
Manpower Risk	Yes	Yes
Credit & Collection Risk	No	Yes
General business Risk	Limited	Yes
Foreign Exchange Risk	No	Yes
Legal Risk	No	Yes

#### Vital Consideration

Accordingly, ABC Group should be characterised as the 'Entrepreneur' and ABC India as 'Limited Risk Bearing enterprise'

# Value drivers and profit portability



**Function, Assets and Risk Analysis**



**Tested Party**

**Key Takeaways**

# Selection of Tested Party

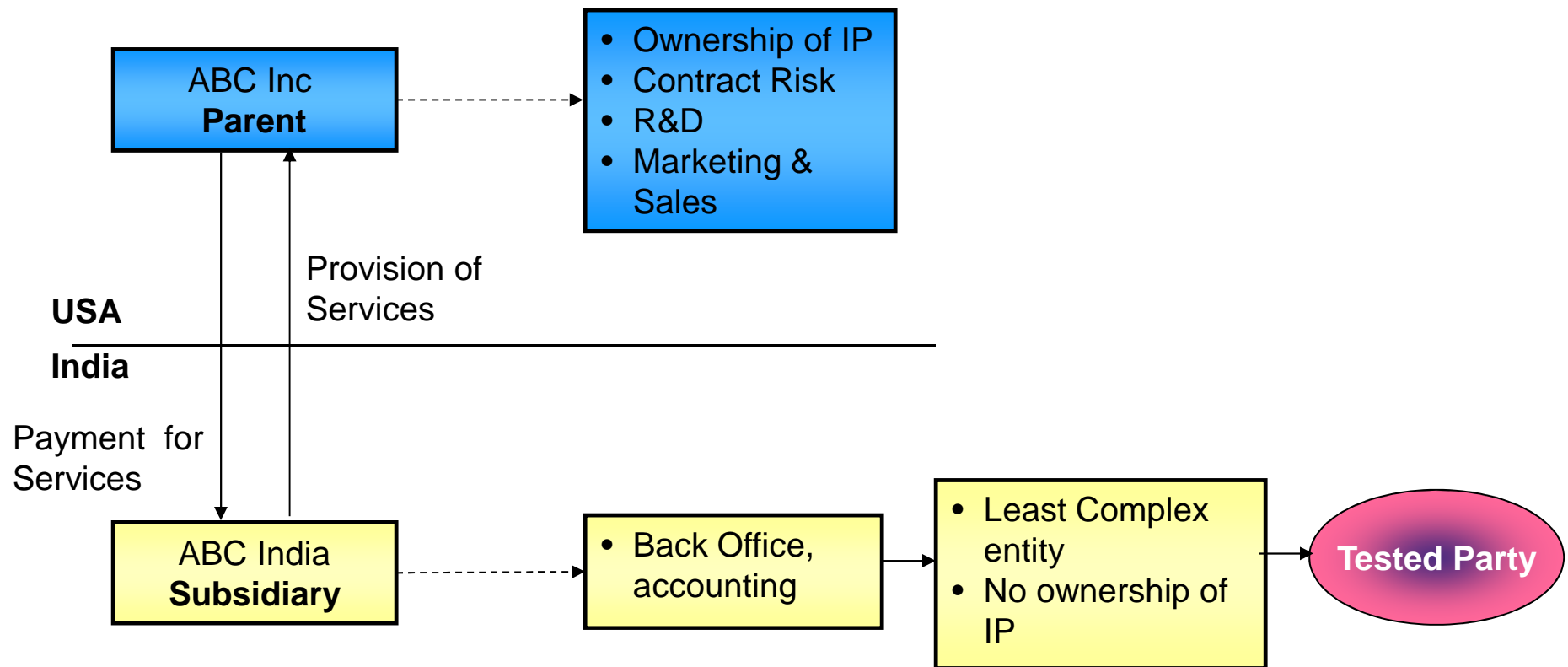
- Participant in an international transaction with whose reference the international transaction is tested
- The selection of the tested party influences the selection of the most appropriate method to benchmark the international transaction and consequently on the comparables selected
- The comparables performing similar functions as the AE in the territory in which the AE operates will have to be selected as comparables
- The term 'tested party' has not been defined in the Indian transfer pricing regulations.



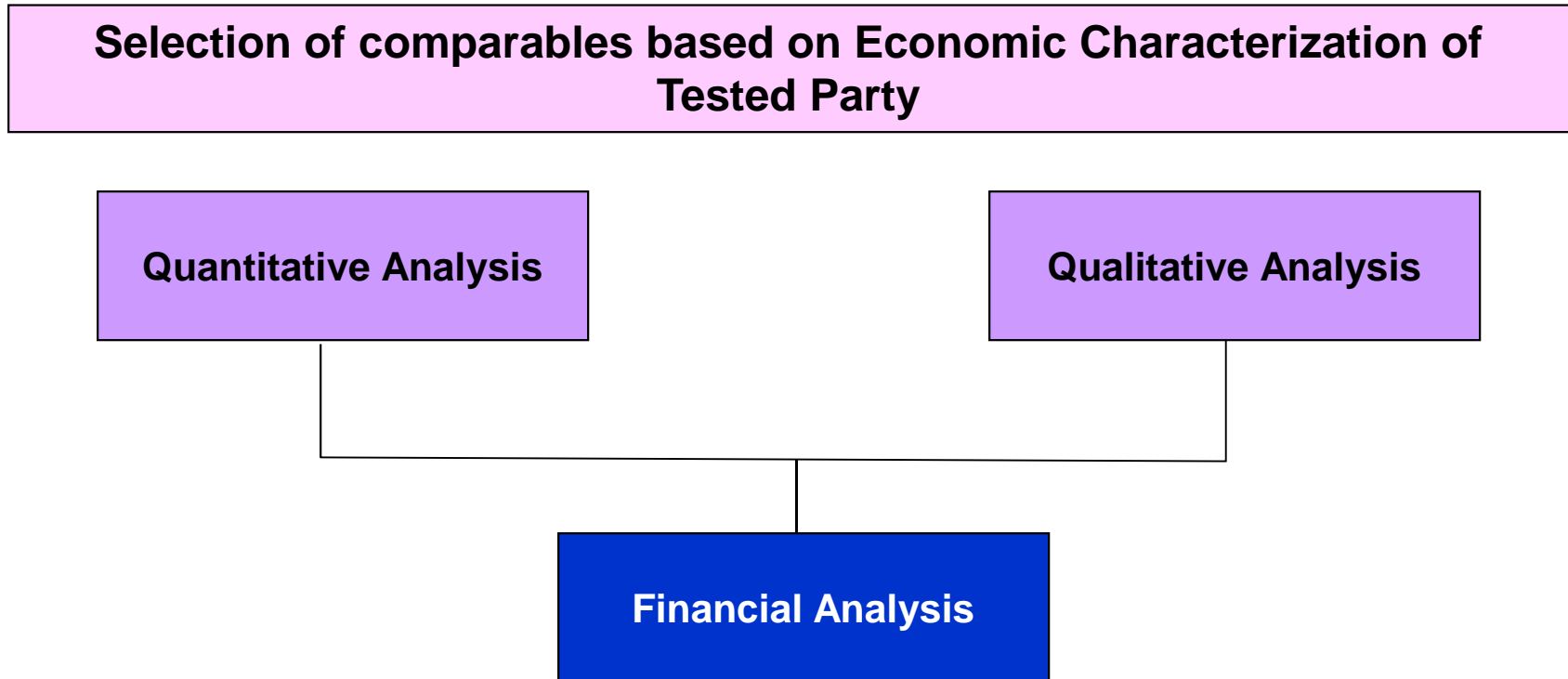
# Selection of Tested Party

- Entity performing simpler functions and not owning any valuable intangibles is normally selected as the tested party
- Availability of the reliable financial information of the comparable companies
- Normally least complex entity selected as the tested party as testing the margin of such entity would require least adjustments

# Selection of Tested Party



# Selection of Tested Party



**Function, Assets and Risk Analysis**

**Tested Party**



**Key Takeaways**

# To summarize....

## Key Takeaways...



**Robust FAR analysis is the foundation of a sound Transfer Pricing Analysis**

**Choice of the tested party should be consistent with the functional analysis of the controlled transaction**

**Selection of Tested Party, plays a central role in the overall application of the arm's-length principle**

**Enough documentation to substantiate**

Thank you

## Open House

