

The background features a complex collage of financial and business-related imagery. On the left, a blue triangle contains the title and presenter information. The main area is filled with various data visualizations: a bar chart with values like 12.5, 25.5, and 50; a line graph with a green trend line; several stacks of gold coins; and various icons such as gears, a lightbulb, and a pie chart. The year '2015' is visible in the upper right, along with the word 'business' and 'economical'. The overall color palette is dominated by gold, blue, and white.

# Function, Asset & Risk Analysis, along with Value Chain Analysis

WIRC | 13 October, 2018  
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# Functions, Assets & Risk (FAR) Analysis

# What is Functions, Assets & Risk (FAR) Analysis

**1** FAR Analysis is an exercise to determine and document significant economic activities performed by the enterprise and its Associated Enterprises (Aes) in a Transaction

**2** Allocation of significant economic activities between those entities involved in the transaction, so each entity can be appropriately characterized

**3** Price charged in any transaction should reflect the functions performed taking into account the risks assumed and assets used

# Components of FAR

## 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

## Assets employed

- **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 returns to be earned by them

## Risk Assumed

- Probable **variability** of future outcomes or returns
- As the risk increases, the vulnerability to earn profit **increases** as well
- The potential risks are **company and industry specific**
- Focus should be on **important risks**
- Important to **distinguish** between which entity bears risks as per legal terms and which one bears as per the conduct of the transaction

# Why do a FAR analysis – Regulations Perspective (1/2)

## Section 92C - Computation of arm's length price

*“The arm's length price in relation to an international transaction 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 or class of associated persons or functions performed by such persons or such other relevant factors ...”*

## Rule 10C(2) - Most appropriate method

*“In selecting the most appropriate method, the following factors shall be taken into account, namely:*

*(b) the class or classes of AEs entering into the transaction and the **functions performed by them taking into account assets employed or to be employed and risks assumed** by such enterprises;...”*

## Rule 10B(2) - Determination of arm's length price under section 92C

Comparability of an international transaction with an uncontrolled transaction shall be judged with reference to (among others):

- Functions performed, taking into account assets employed and risks assumed, by both the parties to the transactions
- Contractual terms (*whether or not such terms are formal or in writing*) which lays down explicitly or implicitly how the responsibilities, risks and benefits are divided between parties to the transactions

## Why do a FAR analysis – Regulations Perspective (2/2)

Para 1.36 (Chapter1) of OECD TP Guidelines ,2017 lists **functional analysis as one of the five factors for comparability analysis:**

*“The functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices”*

**Rule 10D (1) - Documents to be maintained under section 92D**

*“(e) a description of the **functions performed, risks assumed and assets employed** or to be employed by the assessee and by the associated enterprises involved in the international transaction”*

# Process of undertaking FAR analysis

## FAR planning process

- Identify relevant transactions and transacting entities
- Industry and group background
- Review available internal/ external documents

## FAR interviews

- Prepare questionnaires and identify interview contacts
- Create detailed FAR questionnaire
- Conduct interviews and make notes

## FAR Documentation

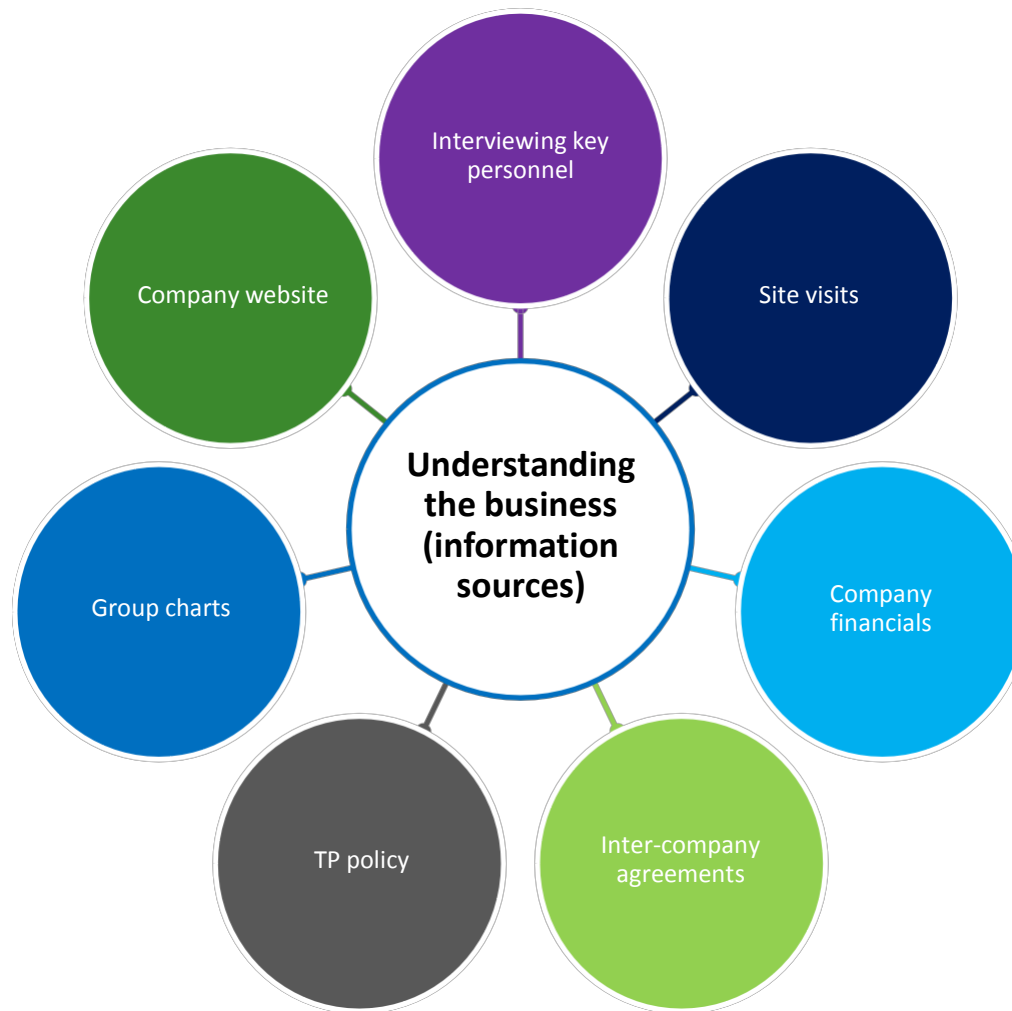
- Summarizing FAR findings in the documentation report/benchmarking memo

## FAR – What to look at

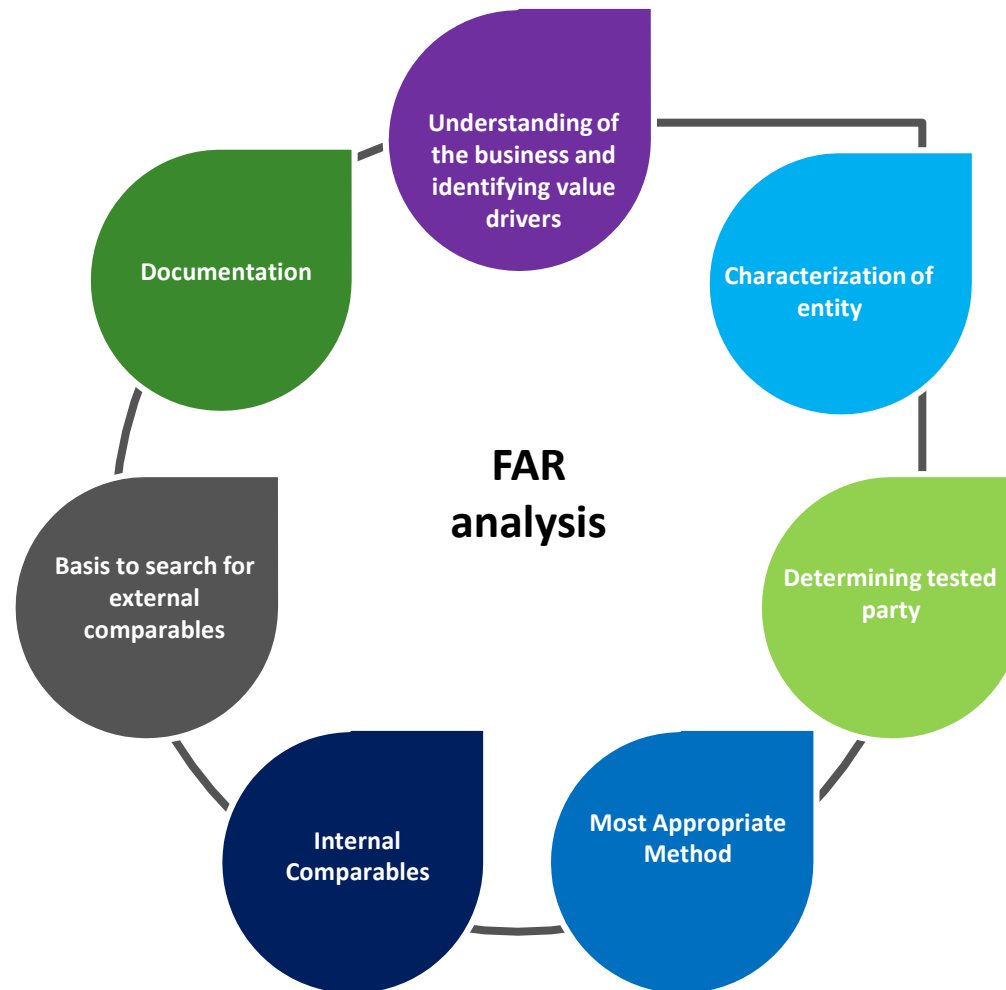




## FAR – Where to look for in Functional Analysis - Sources



# FAR implications



# Fact Finding process

## Gathering basic information

- Background information about enterprise to understand its business operations and activities – (Sources – Annual report, website, internal reports)
- Description of ownership structure of the enterprise
- Profile of multinational group of which the enterprise is a part
- Broad description of the business of the enterprise

## Gathering specific information

- Functions generally performed by each party to the transaction
- Assets generally employed in a transaction
- Risks generally assumed by each party to the transaction
- Contractual terms that have effect on transfer prices are also to be examined (sources – written contracts, agreements)

## Gathering relevant documents

- Agreements, common group policies
- Product brochures, marketing materials
- Documents providing information such as marketing strategies, pricing strategies
- Information about major competitors, customers, market etc.

# Key Factors in FAR Analysis

**01** Sheer volume of functions performed is **not decisive** -What is relevant is the **relative importance of each function**

**02** Functions performed may be few but significant

**03** Identify **each party's contribution (Taxpayer & AE)** to every function performed

**04** Functions are the main domain for identifying and assigning risks to an entity

**05** Aggregation of International Transactions **-only if FAR analysis of such transactions is aligned**

# Entity Characterization under FAR

01

Entity characterization is one of the main objectives of functional analysis

02

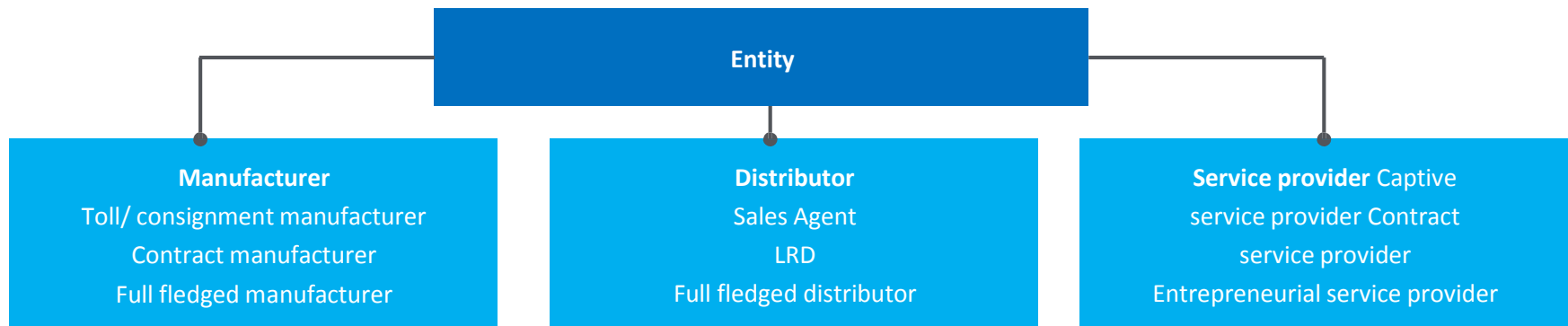
Entity characterization is a link between the business processes, and the way the entities participate in them. It focusses on the key feature of the various entities, regarding how they do business

03

Characterization of the related parties is an important component to a transfer pricing analysis and is typically used as the foundation in developing economic analysis

04

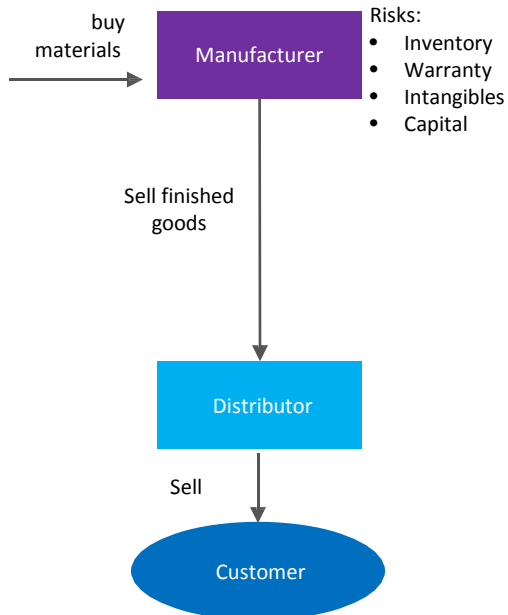
It is a summary of the crucial characteristics which defines the type and nature of an entity and provides insight on type of comparables that will be required to benchmark the related party transaction



# Manufacturers – Typical Models

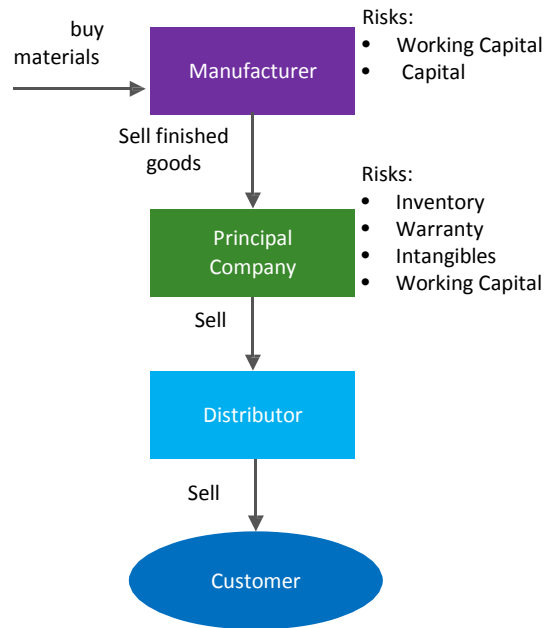
## Traditional / “Fully fledged” Manufacturing

The manufacturer owns intangibles and manufactures product for its own risk and reward



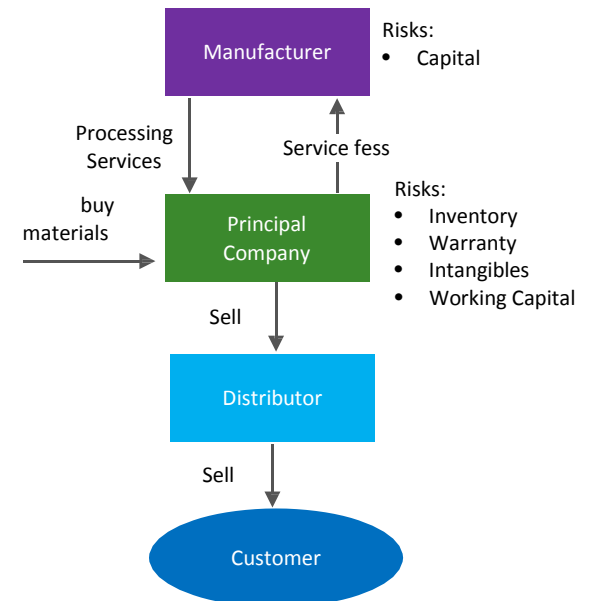
## Contract Manufacturing

A contract manufacturer produces goods to order for and for the risk of the principal company. A contract manufacturer buys materials and sell finished goods to principal. However, it has less risk and earns a lower profit than a traditional manufacturer

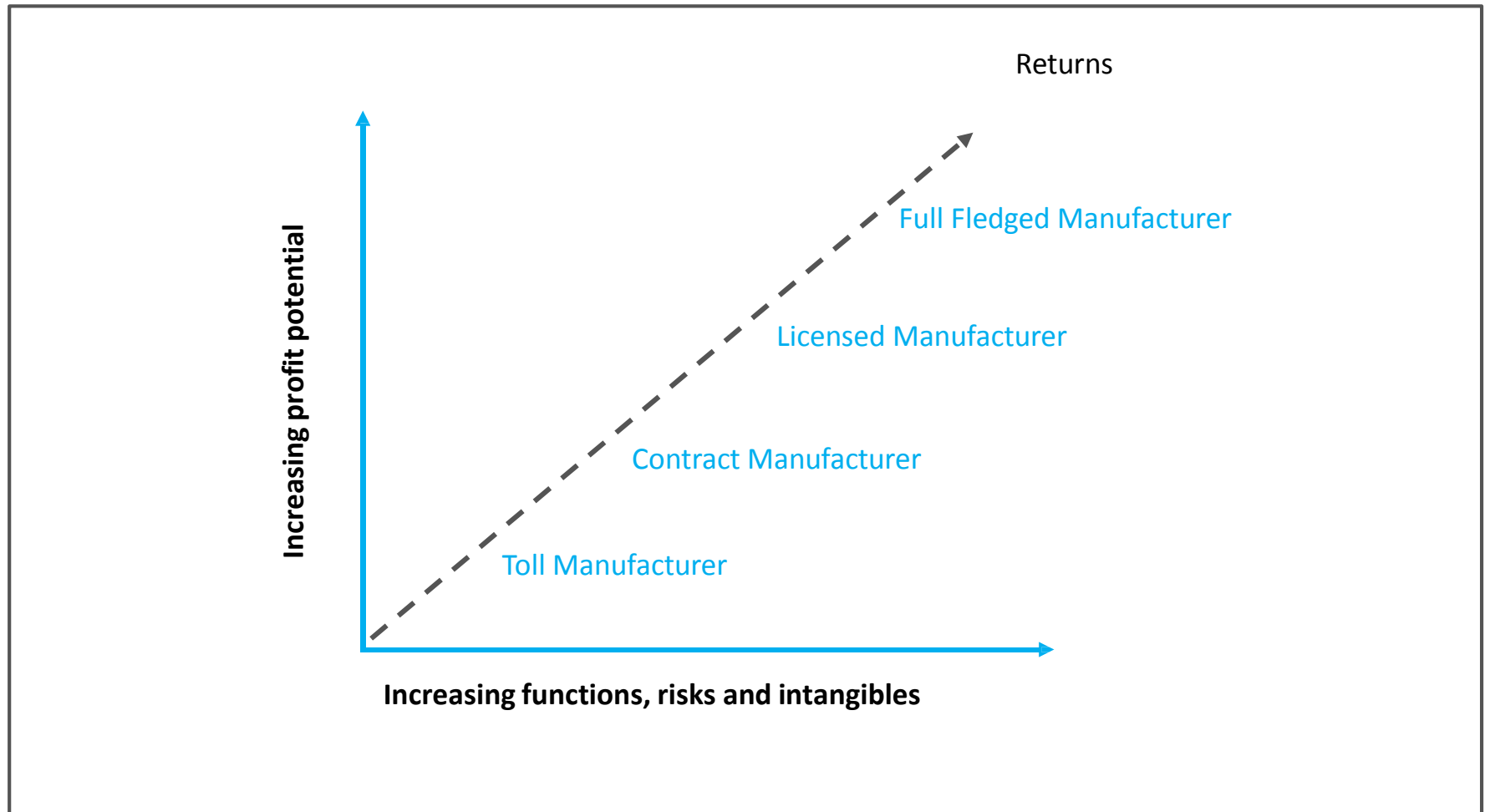


## Toll / Consignment Manufacturing

A toll / consignment manufacturer processes goods belonging to the principal company and never takes ownership. It assumes less risk and earns a lower return than a traditional manufacturer



# Manufacturers – Expected Profitability



# Distributors – Typical Models

## Fully fledged Distributors

A full distributor bears market risk, holds inventory for its own risk and sells to the customer as principal. The distributors profit margin reflects its risks and functions

## Limited Risk Distributors

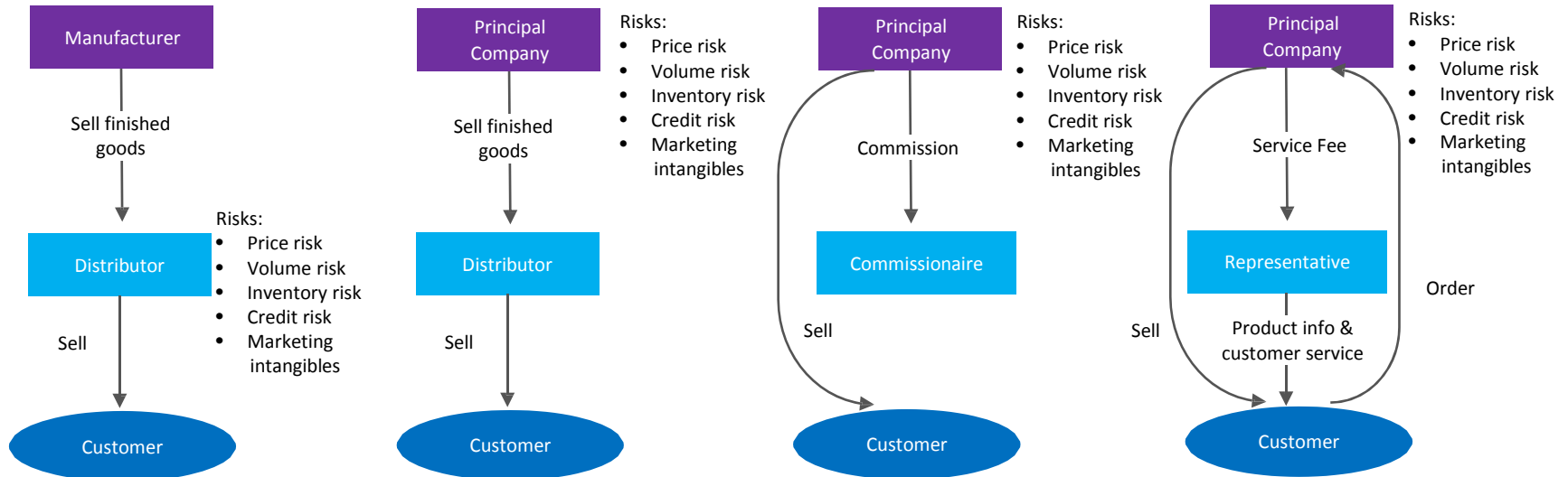
A master distributor bears market risk and inventory risk. The local limited risk distributors buy product from the master distributor and resell the product to the customer. The limited risk distributors earn a lower profit than a full distributor, consistent with their reduced functions and risk

## Commissionaire

A civil law concept whereby the commissionaire sells product in its own name but for the account of the principal. The risks and benefits of the sale (and the profit) rest with the principal. The commissionaire receives a commission which provides it with a lower profit than a full distributor, consistent with its reduced functions and risks

## Representative

The local sales company acts as a representative that is not directly involved in making sales. It merely provides product information and performs customer service. The principal receives sales orders directly from customers - either in a call centre or electronically. The local representative earns a lower profit than a full distributor, consistent with its reduced functions and risks





# Service Providers - Models

## Full Service Provider

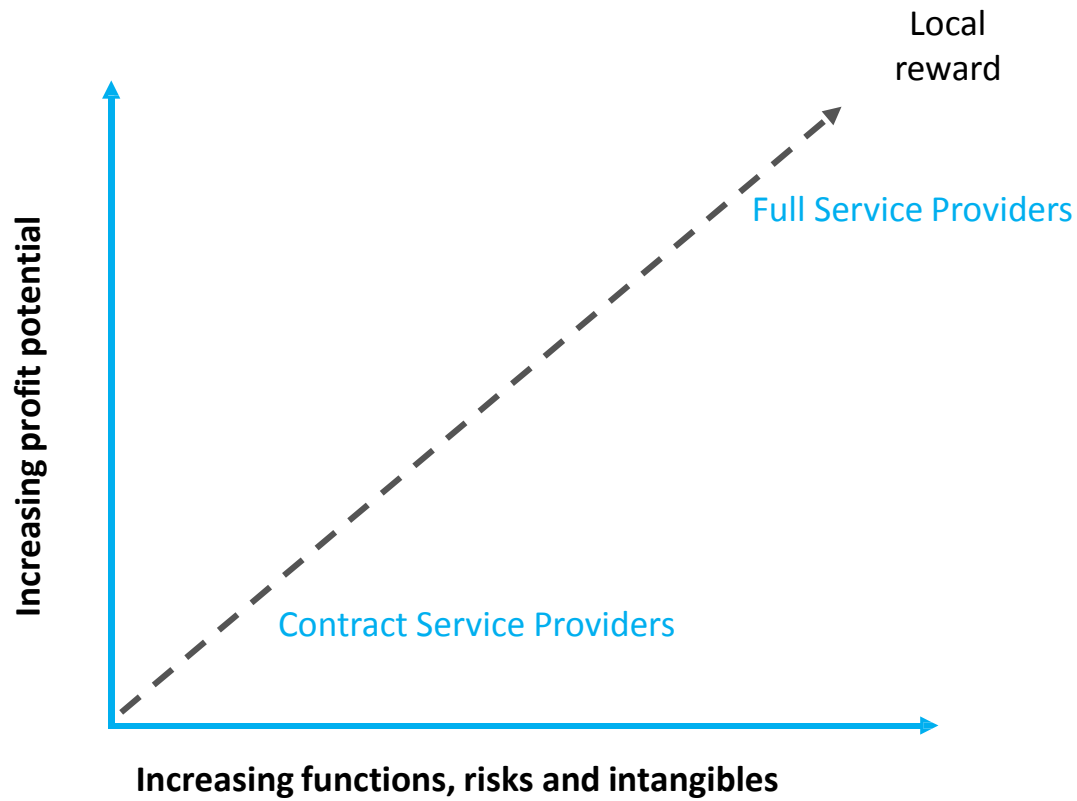
- Develops and markets its own services to its own clients
- Usually has the strategic marketing and operational responsibilities of its operations
- The main functions performed by full service providers may include all or any of the following:
  - providing services
  - market research
  - strategic marketing
  - service advertising
- Risks borne include market risk, credit risk etc.
- May also develop marketing intangibles such as customer relationships, trademark recognition and specialized customer service expertise
- Entitled to residual profit

# Service Providers - Models

## Contract Service Provider

- Performs services not for itself but on behalf of other entities under following contractual terms and conditions:
  - The contractor, i.e., entity performing the service, will bear no market risk (i.e. the risk associated with fluctuations in demand), as the developer or entity acquiring the services will agree to purchase the output produced under the contract service agreement
  - The developer will provide the contractor with detailed specification based on its know-how and intellectual property developed as a result of research and development
  - The contract service provider will bear all the risk associated with the ownership, maintenance and operation of the equipment it uses
- Normally compensated in following models:
  - a cost-plus mark-up model; or
  - a standard rate card model.
- Enjoys relatively lower though stable margins; principal is entitled to residual profits

# Service Providers - Profitability



# Typical FAR of Manufacturers

FAR	Types of Manufacturer			
	Full Fledge	Licensed	Contract	Toll
<b>Functions and Assets</b>				
Owns non-routine technology i.e. IP	Yes	No	No	No
Owns Material	Yes	Yes	Yes	No
Manufactures for himself	Yes	Yes	No	No
Marketing	Yes	Yes	No	No
Sales and distribution	Yes	Yes	No	No
<b>Risk</b>	<b>Normal</b>	<b>Less than Normal</b>	<b>Limited</b>	<b>Minimal</b>
Market risk	Yes	Yes	N (Minimal)	N (Minimal)
Price risk	Yes	Yes	No	No
Inventory risk	Yes	Yes	Yes	No
Capacity risk	Yes	Yes	Limited	No
Product liability risk	Yes	Yes	No	No
Warranty risk	Yes	Yes	Limited to re-work	Limited to re-work
Technology R&D risk	Yes	No	No	No

# Benchmarking filters

Indicative ratios	Types of Manufacturer			
	Full Fledge	Licensed	Contract	Toll
R&D/Sales	Yes	No	No	No
Inventory/sales	Yes	Yes	Yes	No
Intangible assets/total assets	Yes	No	No	No
Royalty/Sales	No	Yes	No	No
Raw material/total cost	Yes	Yes	Yes	No
AMP expense/sales	Yes	Yes	No	No
Plant & machinery/Gross fixed assets	Yes	Yes	Yes	Yes

# Typical FAR of Distributors

FAR	Types of Distributor		
Functions and Assets	Market	Normal	Limited risk
Marketing	Yes (extensive)	Yes (within industry standards)	Minimal
After sales services	Yes	Yes	Yes
Inventory management	Yes	Yes	Minimal
Customer list	Yes	Yes	No
Warehousing facilities	Yes	Yes	Yes
Marketing intangibles	Yes	No	No
Furniture/fixtures/communication facilities	Yes	Yes	Yes
Risk	Normal	Less than Normal	Limited
Market risk	Yes	Yes	Minimal
Price risk	Yes	Yes	No
Inventory risk	Yes	Yes	Minimal
Product liability risk	No	No	No
Credit risk	Yes	Yes	No
Warranty risk	Yes	Yes	No

# Benchmarking filters

Indicative ratios	Types of Distributor		
	Market	Normal	Limited risk
Marketing expense/ total cost	High	Within industry standards	Minimal
Inventory levels	High	Medium	Minimal

# Typical FAR of Service Providers

FAR	Types of service providers	
	Entrepreneur/Normal risk service provider	Limited risk/captive service providers
<b>Functions and Assets</b>		
R&D	Yes	No
Significant people functions	Yes	No
Quality	Yes – assume overall responsibility	Limited to the extent of services performed
Marketing	Yes	No
<b>Risk</b>	<b>Normal</b>	<b>Limited</b>
Man power recruitment/attrition	Yes	Yes
Service liability	Yes	No
Capacity utilization risk	Yes	No
Regulatory	Yes	No
Foreign exchange	Yes	No
Credit risk	Yes	No - Advances



# Benchmarking filters

Indicative ratios	Types of service providers	
	Entrepreneur/Normal risk service provider	Limited risk/captive service providers
Employee cost/ Sales	High	High
Intangible assets/Total assets	Yes	No
R&D/Sales	Yes	No

# Final remarks on FAR

01

How to get in conversation with client on FAR

02

Support services – employee qualification can answer

03

Unique about product as compared to competitors

04

IP – Developed in India?

05

Appropriate FAR helps in comparability adjustments



# Basics of VCA

## Value

- The value is the total amount (i.e. total revenue) that buyers are willing to pay for a firm's products
- The difference between the total value (or revenue) and the total cost of performing all of the firm's activities provides the margin
- The idea of value chain was developed by Michael Porter in 1985

## Value Chain

- In a transaction flow, products or services pass through the chain of value adding activities and gain value at each stage
- A value chain is the whole series of an MNE's activities that create and build value at every stage of doing business
- When these stages are spread to different parties in an MNE group, the question arises as to which party creates what value and how this value is to be remunerated
- Porter's definition includes all activities to design, produce, market, deliver and support the product/service
- The value chain is concentrating on the activities starting with the raw materials till the conversion into final goods or services
- Two categories:
  - Primary activities (operations, distribution, sales)
  - Support activities (R&D, human resources)

## Types of Value Chain

Value chain is categorized into types based on the types of organizations

- Manufacturing based
- Service based
- Both manufacturing and service based

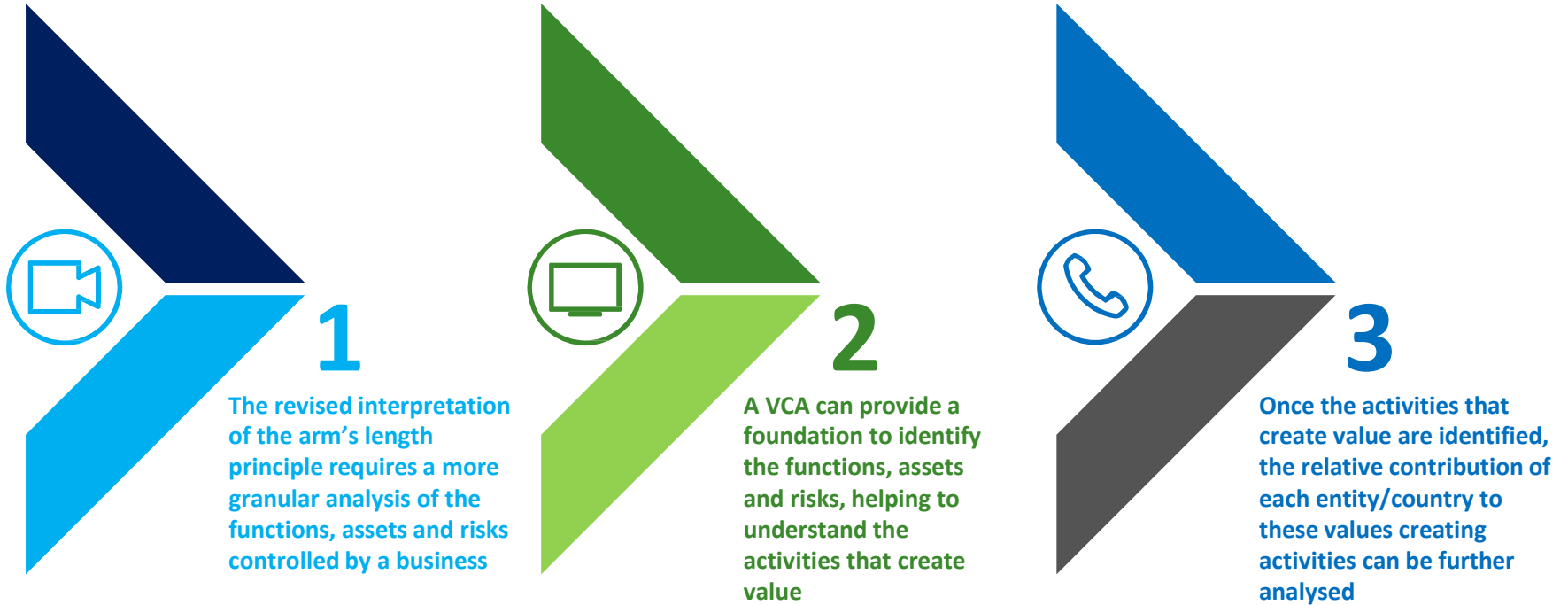
# What is VCA?

- A VCA is a tool to understand how value is created in the enterprise
- A VCA identifies key value drivers as part of company's value chain
- A VCA considers where and how value is created in the business operations including
  - Economically significant functions, assets and risks;
  - Which company performs the functions, contributes the assets and assumes the risks
  - How functions, assets and risks are interrelated;
  - How the economic circumstances may create opportunities to capture profits in excess of what the market would allow; and
  - Whether the value creation is sustainable
- Used to identify sources of competitive advantage
- Specifically:
  - Opportunities to secure cost advantages
  - Opportunities to create product/service differentiation
- Includes the value-creating activities of all industry participants

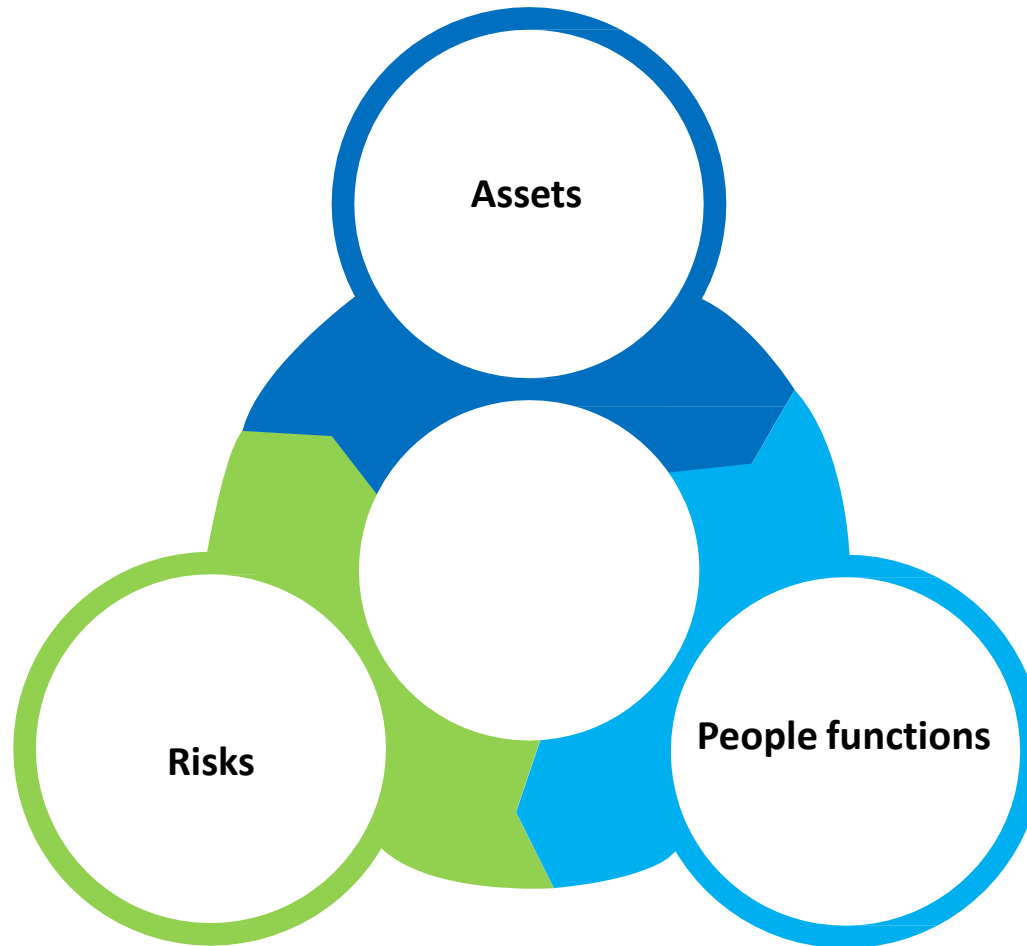
## Why VCA is required in today's scenario?

- The following are now questionable in the light of VCA analysis under BEPS:
  - One-sided benchmarks
  - IP-structures which do not absorb any costs
  - Commissionaire structures drawing disproportionate limited and fixed return
  - Geographically fragmented IP structures

# Why VCA is helpful?

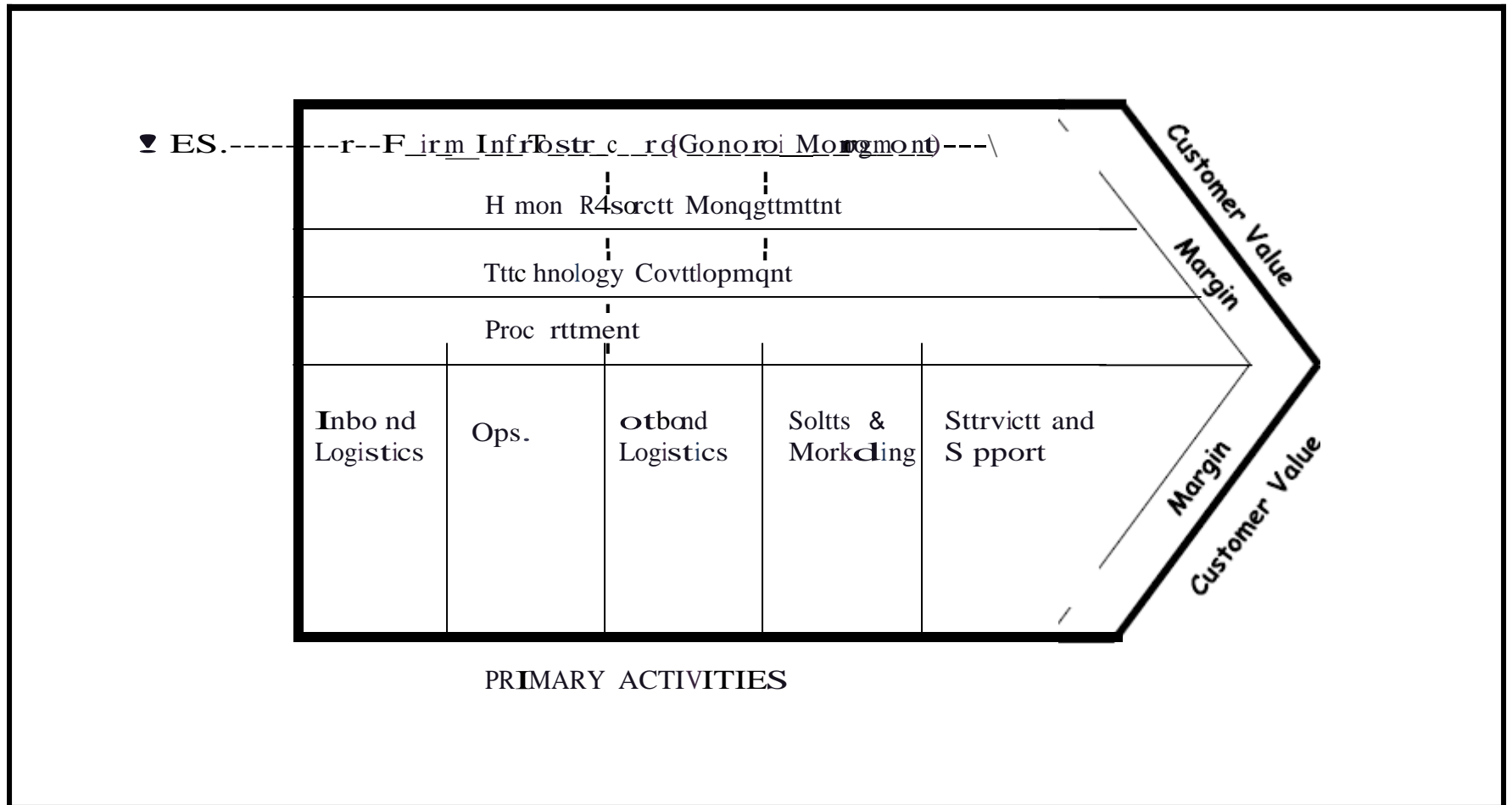


# The new transfer pricing...





# Value Chain Model (Fish Bone Diagram)



## Primary activities

Those that are involved in the creation, sale and transfer of products (including after-sales service)

Types of primary activities	Examples
Inbound logistics	<ul style="list-style-type: none"><li>• Concerned with receiving, storing, distributing inputs (e.g. handling of raw materials, warehousing, inventory control)</li></ul>
Operations	<ul style="list-style-type: none"><li>• Comprise the transformation of the inputs into the final product form (e.g. production, assembly and packaging)</li></ul>
Outbound logistics	<ul style="list-style-type: none"><li>• Involves collecting, storing and distributing the product to the buyers (e.g. processing of orders, warehousing of finished goods and delivery)</li></ul>
Sales and marketing	<ul style="list-style-type: none"><li>• Identification of customer needs and generation of sales (e.g. advertising, promotion and distribution)</li></ul>
Service and support	<ul style="list-style-type: none"><li>• Involves how to maintain the value of the product after it is purchased (e.g. installation, repair, maintenance and training)</li></ul>

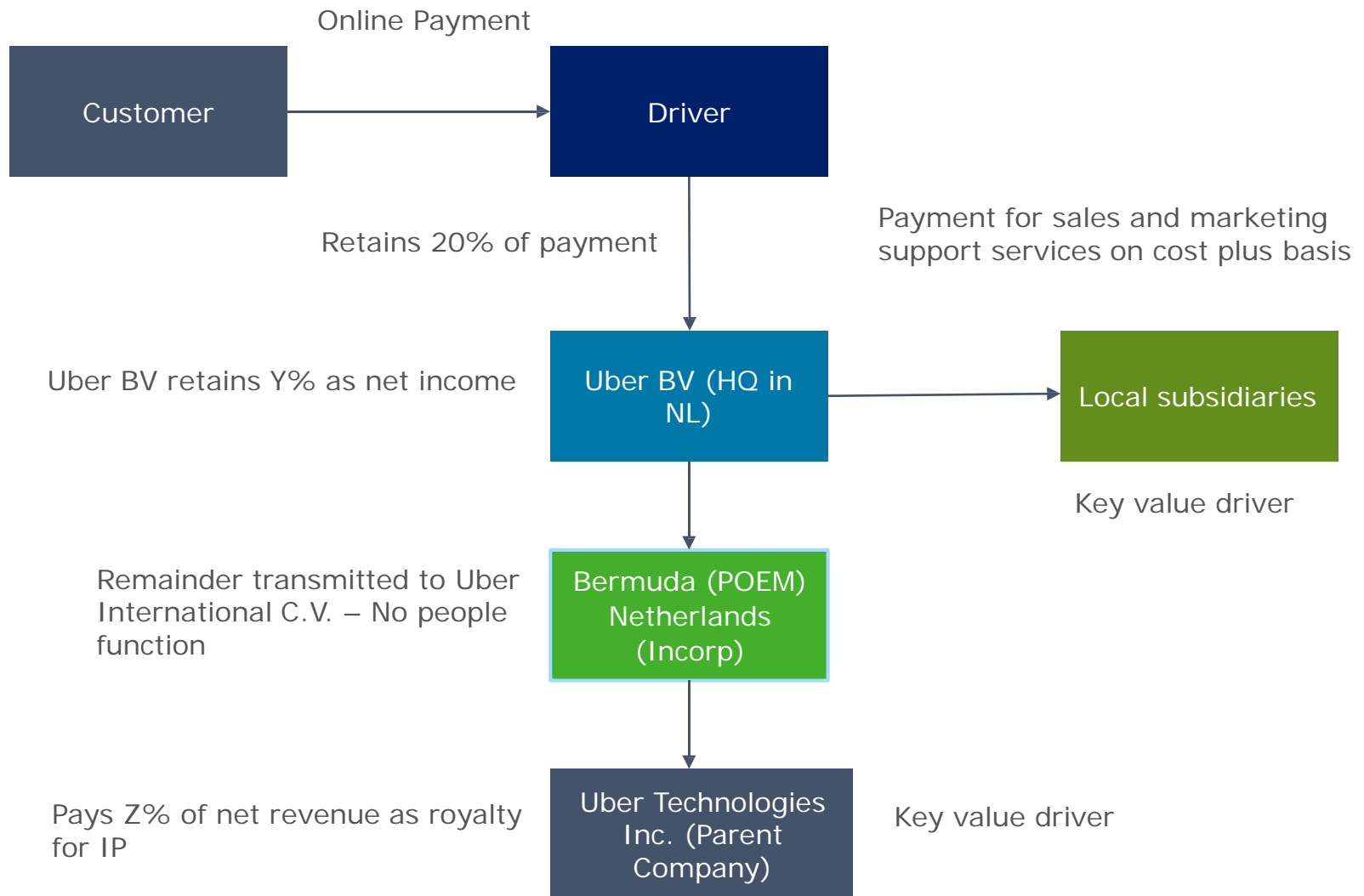
# Support activities

Those that merely support the primary activities

Types of support activities	Examples
Firm infrastructure	<ul style="list-style-type: none"><li>• The activities such as organization structure, control system, company culture are categorized under firm infrastructure</li></ul>
Human resource management	<ul style="list-style-type: none"><li>• Involved in recruiting, hiring, training, development and compensation</li></ul>
Technology development (not leading to creation of intangible)	<ul style="list-style-type: none"><li>• These activities are intended to improve the product and the process, can occur in many parts of the firm</li></ul>
Procurement	<ul style="list-style-type: none"><li>• Concerned with the tasks of purchasing inputs such as raw materials, equipment and even labor</li></ul>



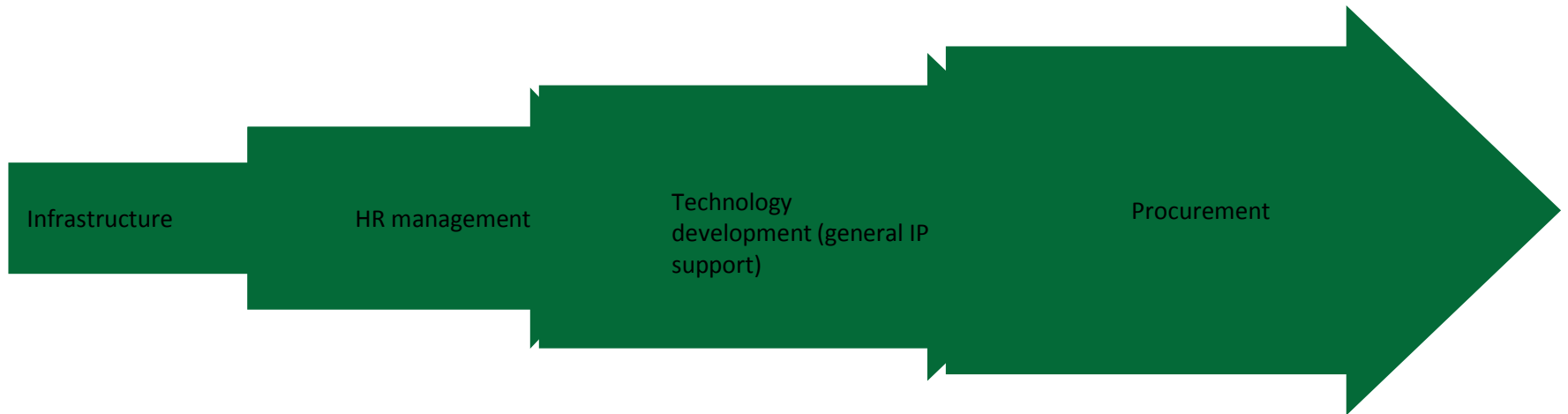
# Uber structure



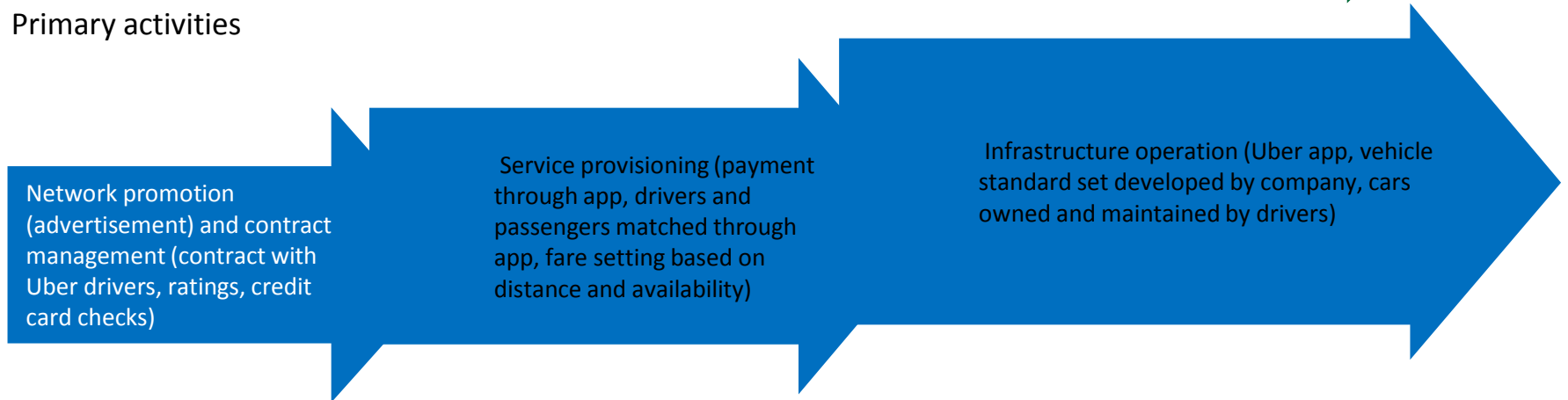
# Identification of primary activities and support activities

Uber

## Secondary activities

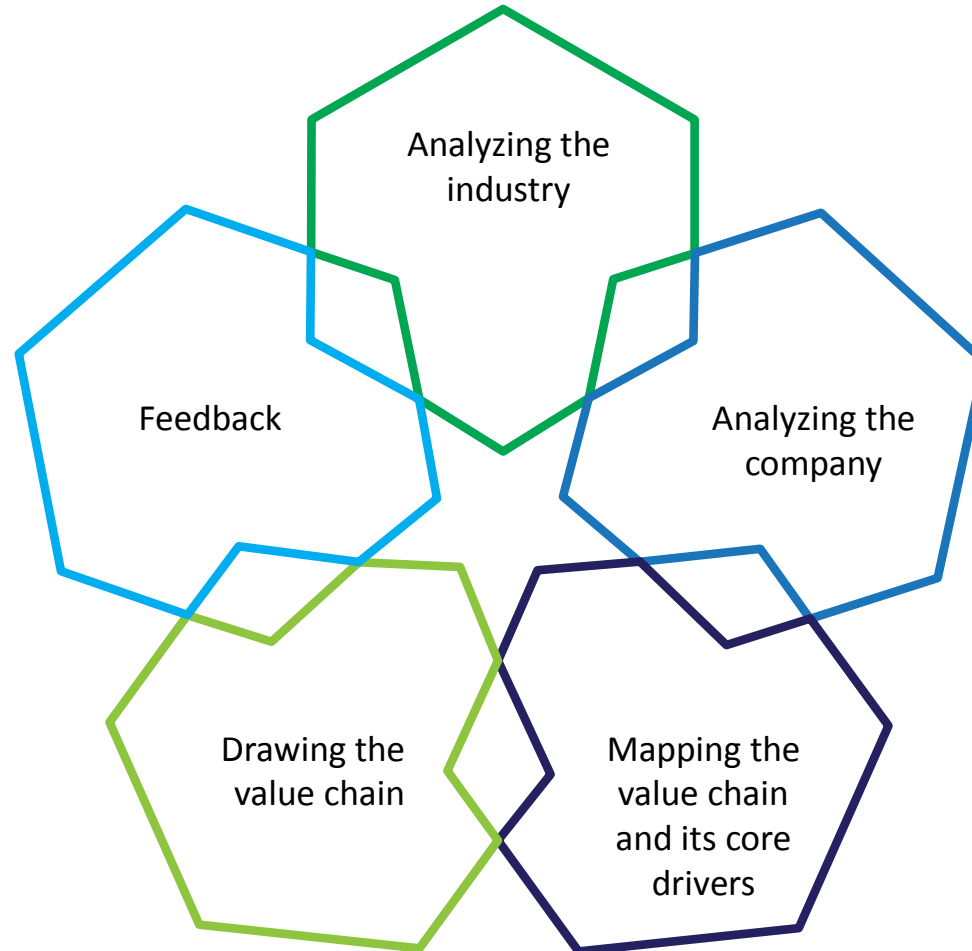


## Primary activities



# Value Chain Analysis – For transfer pricing purposes

## Five Steps process



## Step 1 – Analyzing the industry

- The first step of industry analysis is the description of the product or service and its regional or geographic scope
- Analysis of five forces identified by Michael Porter:
  - Suppliers: bargaining power of suppliers;
  - Potential entrants: threat of new entrants;
  - Buyers: bargaining power of buyers;
  - Substitutes: threat of substitute products or services
  - Rivalry among existing competitors (firms)
- Analysis of five forces will help to understand the company's position and importance of a specific value chain within that specific industry
- This step will help in determining company's position in relation to its competitors, to the industry and relative to the five forces



## Step 2 – Analyzing the Company

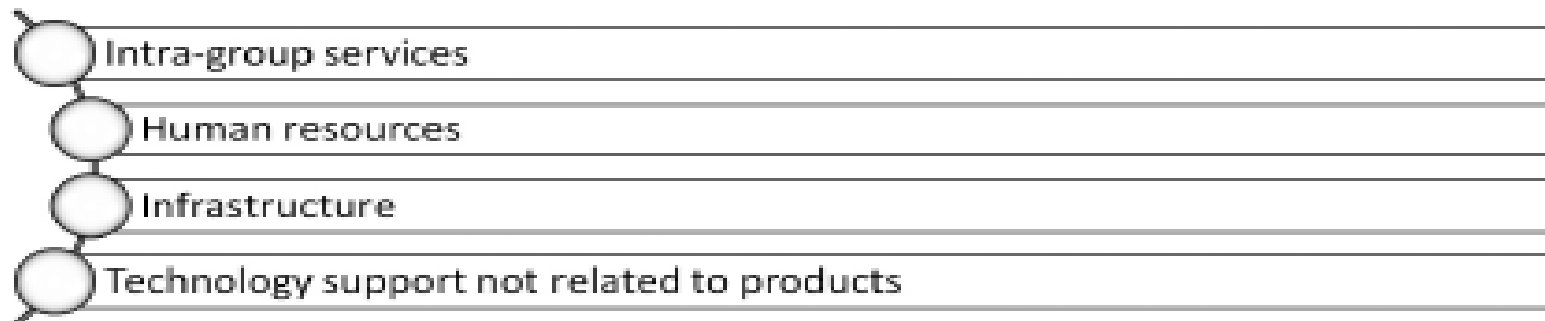
- Analyzing the company is a matter of placing the MNE within that industry in terms of market share, competition, history, diversification
- Conduct SWOT analysis – SWOT analysis will help in analyzing the company from an internal perspective
- Checking the size of the company, open possibilities of expansion and M&A strategies
- Cost-saving strategies, key performance indicators, restrictive policies and corporate governance
- Check whether company has competitive advantage. If yes, then company would be operating at lower cost and can demand premium price or both
- Analyze return on invested capital (ROIC). ROIC is the financial measure used to analyze whether a company operates as an average player within an industry or whether it really possesses an advantage
- ROIC represents in numbers how well a company is using its resources to generate returns
- Compare the ROIC with competitors or other MNEs in the same industry
- $ROIC = (\text{Net Income} - \text{dividends}) / \text{total capital}$

## Step 3 – Mapping the value chain and its core drivers

- The purpose of this step is to map the company supply chain (i.e. identification of primary and support activities) and its core drivers
- Analyzing the sequence of activities of the group that are performed to design, manufacture, market, sell, deliver and support its products or services
- What factors affect cost of product or service
- What are main value drivers
- Traditional supply chain

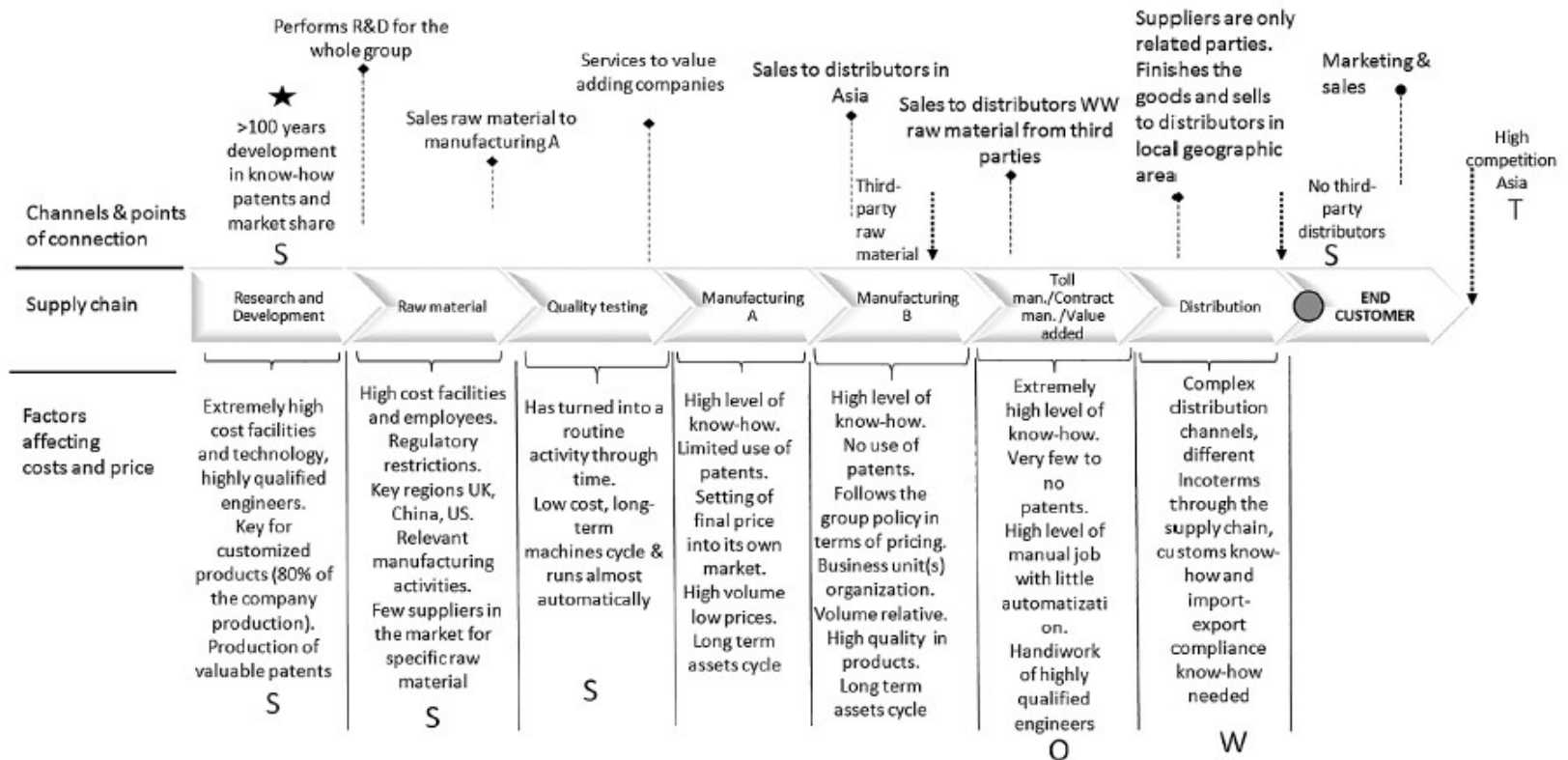


- Mapping of supply chain for secondary activities:

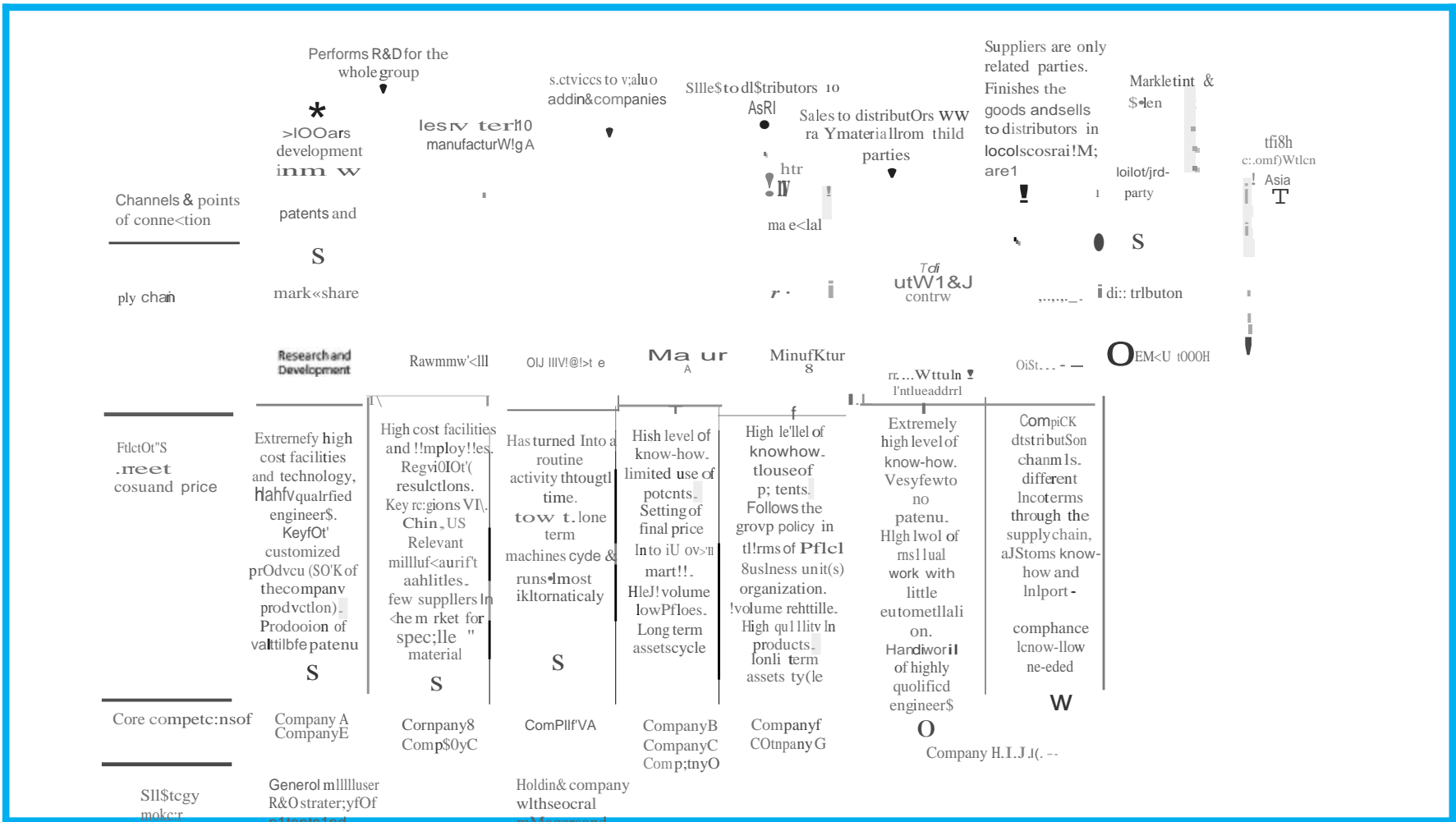


# Step 4 – Drawing the value chain

- In this step, draw the value chain to determine which legal entity performs which functions within the supply chain



# Step 4- Example



## Step 5 – Feedback

- Receive feedback (during all steps of VCA) from select group of people with MNE
- Feedback will serve as sanity check before finishing the exercise
- Feedback from key people of the company. To identify key people will depend upon the type of company. For example – in case of manufacturing entity, the key areas are R&D, logistics, marketing and sales, quality management.



# How to conduct VCA - Summary

## A VCA involves following steps:

- Mapping out the generic value chain for the industry
- Mapping out and MNE's value chain
- Comparing generic value chain vs MNE's value chain, analyzing differences that may explain why MNE has clear advantage over its competitors
- Distinguishing between MNE's main functions and support functions
- Identifying and understanding which main functions are critical to the success of the organization (critical success factors)
- Identifying and understanding which activities performed add how much value to the goods and services it produces (value adding activities)
- Understanding and confirming how the various functions across the value chain are split by the MNE between various legal entities in the group (determining the contributions and value added of each group company)





# Uses of VCA

- Helps in understanding company's position within an industry, the external and internal factors affecting the performance, the nature of supply chain and most importantly what each legal entity within the group is doing that create value for that company in that industry
- Helps in aligning transfer pricing policy with company strategy
- Understanding the VCA will also facilitate the planning and reviewing of transactional transfer pricing policies
- VCA assists in accurately delineating a transaction, in particular with respect to functional analysis
- VCA provides useful insight into:
  - Key value drivers of the transaction
  - The nature of the contributions of assets, functions and risks by the associated enterprises to the key value drivers
  - Which parties can protect and retain value through performance of important functions in relation to DEMPE of intangibles
  - Which parties assume economically significant risks or perform control functions relating to economically significant risks associated with value creation
  - How parties operate in combination with each other in the value chain and share functions and assets in parallel integration
- VCA are helpful in the process of determining the relevant factors to use in splitting profits, including the weighing of splitting factors



# China local file requirements

01

VCA is part of local file requirement

02

No guidance on how to prepare for VCA in Bulletin 42

03

Local file is required to disclose financial statements of participating entities along value chain, and the group profit allocation principle and result

04

China tax authorities are keen to apply VCA in both audit and APA cases

05

Value chain has been applied to map China taxpayer's role and position in the group, to evaluate the fairness of its profit share received