COST AUDIT REPORT
AND
TRANSFER PRICING

The Institute of Cost Accountants of India

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Points for consideration

- Cost Audit Report
- Related Party
- Indian Transfer Pricing Regulations
- Comparable Uncontrolled Price Method
- Resale Price Method
- Cost Plus Method
- Profit Split Method
- Transactional Net Margin Method
- Safe Harbour Rules
- Some Issues
- Way Forward

Cost Audit Report

Section 148 :

- The Central Government may by order in respect of such class of companies engaged in production of such goods or providing such services as may be prescribed, direct that particulars relating to the utilization of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by such class of companies.
- Cost Audit Records to be audited by a Cost Accountant

Cost Audit Report (Cont'd…)

Section 148 :

- Cost Audit Report has to be submitted to the Central Government within 30 days of it submission to the Board of Directors alongwith the explanations on reservations/ qualifications of the Cost Auditor
- If provisions of section 148 are not complied with
  - As per section 147(1) – The Company and every officer of the company who is in default shall be punishable with a fine of Rs.25,000 to Rs.500,000 and every officer may also be punishable with imprisonment plus a fine.

Cost Audit Report (Cont'd…)

Section 148 :

- As per section 147(2) to (4) – The Cost Auditor in default shall be punishable with a fine of Rs.25,000 to Rs.500,000
  - ***Proviso If an auditor has contravened the provisions knowingly and willfully with the intention to deceive the company….. tax authorities, he shall be punishable with imprisonment ….***
- The Cost Auditor shall be liable for returning the fees **and also to pay** damages to the company, statutory bodies … for loss arising out of incorrect or misleading statements of particulars made in his audit report
- Following of "Cost **Auditing** Standards" mandatory for the Cost Accountant – However, there are no notified Cost Auditing Standards as of now. Difference between GAAP and GAAS.

Cost Audit Report (Cont'd…)

- Cost **Auditing** Standards would certainly assist Cost Accountants while discharging their attest function
- 39 Standards on Auditing issued by the ICAI:
  - Terms of Audit Engagements
  - Audit Documentation
  - Communication of Audit Matters with those charged with Governance
  - Planning and audit of financial statements
  - Audit Materiality
  - Understanding the entity and its environment and assessing the risks of material misstatement
  - Auditors procedures in response to assessed risk
  - Using the work of another Auditor……. Etc.

Cost Audit Report (Cont'd…)

As per the **Companies (Cost Records and Audit) Rules 2014** read with the **Companies (Cost Records and Audit) Amendment Rules 2014 [hereinafter referred to as "Cost Audit Rules"]**

- The Cost Records need to be maintained in Form CRA-1

  The Cost Records should facilitate

  - Calculation of per unit cost of production or cost of operations
  - Cost of sales **and margin** for each of its products and activities

- Every Cost Auditor shall submit his report (CRA-3) to the Board of Directors of the Company within a period of 180 days from the closure of the financial year

- Section 143(12) – Also applicable to Cost Auditors – In an auditor of the company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by the officers or employees of the company, he shall immediately report the matter to the Central Government

Related Party Transactions

Definition of Related Party as per Cost Audit Rules

- Related party transactions are to be reported under para 24 of the Form CRA-1 (Cost Audit Records)
- Meaning of related party is derived from Section 2(76) of the Companies Act, 2013. This is a very broad definition, covering holding companies, subsidiary companies, associate companies, a private company in which a director is member or director, etc.
- Definition as per Income Tax Act is narrower as compared to Section 2(76). For instance - In two private companies there is a common director and hence section 2(76) is attracted, however, section 92A(2)(b) may not be attracted as the two private companies are totally independent and neither does the director have any shareholding links.
- Disclosure of related party transactions in financial statements are still as per Accounting Standard 18

Related Party

Related Party Transactions (Cont'd…)

Coverage of Related Party Transactions as per Cost Audit Rules

- Purchase and sale of raw materials, finished goods, rendering of services, process materials and rejected goods including scraps and other related materials;
- Utilisation of plant facilities and technical know-how;
- Supply of utilities and any other services;
- Administrative, technical managerial or any other consultancy services; *(management fees charged)*
- Purchase and sale of capital goods including plant and machinery; and
- Any other payment **related to** the production of goods or rendering of services under reference

Related Party Transactions (Cont'd…)

Coverage of Related Party Transactions as per Income Tax Act

- …….**Any other payment related to** the production of goods or rendering of services under reference
- Issue of shares
- Bank guarantee transactions
- Payment of interest on loans
- Deemed International Transactions
- Any other transaction **having a bearing on** the profits, income, losses or assets of the company, for instance – payment of dividend, etc.

More or less, transactions disclosed for Transfer Pricing would mostly be covered under the Cost Audit Records. Although related parties coverage is more than those covered under Companies Act or Transfer Pricing, the reportable transactions will be lower in Cost Audit Records

Related Party Transactions (Cont'd…)

Disclosure in the Annexure to the Cost Audit Report

- Under para no.5 Related Party Transactions (for the company as a whole)

Sr. No.	Name and Address of the Related Party	Name of the Product/ Service	Nature of Transaction (Sale, purchase, etc.)	Qty	Transfer price	Amount	Normal Price	Basis adopted to determine the Normal Price

Footnote : Details of related party transactions **without indicating the Normal Price and the basis thereof** shall be considered as **<u>incomplete information.</u>**

- Transfer Price – Price as per books of account
- Normal Price – As defined under para 24 in the Form CRA-1

Related Party Transactions (Cont'd…)

Disclosure in the Annexure to the Transfer Pricing Audit Report

- Form 3CEB specifies the format of disclosure for various transactions
- For instance disclosure for import of raw materials, the disclosure is as follows:

Sr. No.	Name and Address of the Associated Enterprise	Description of the transaction	Quantity Purchased	Amount paid/ payable for the transaction		Method used for determining the arm's length price
				As per Books of Account	As computed by the Assessee	
				Transfer Price	Normal Price	

Related Party Transactions (Cont'd…)

Normal Price

- Normal Price is defined under para 24 of the Form CRA-1 (Cost Audit Records) – Means – price charged for comparable and similar products in the **ordinary course of trade and commerce** where the price charged is the sole consideration of sale and such sale is **not made to a related party**. Normal price can be construed to be a price at which two ***unrelated*** and ***non-desperate parties*** would agree to a transaction and where such transaction is **not clouded due to the proximity** of the parties to the transaction and **free from influence** though the parties may have shared interest.

Arm's Length Price

- Means – a price which is applied or proposed to be applied in a transaction between persons ***other than associated enterprises***, in uncontrolled conditions.

Related Party Transactions (Cont'd…)

Basis to determine the Normal Price and Arm's Length Price

Normal Price	Arm's Length Price
Comparable Uncontrolled Price Method	Comparable Uncontrolled Price Method
Resale Price Method	Resale Price Method
Cost Plus Method	Cost Plus Method
Profit Split Method	Profit Split Method
Transactional Net Margin Method	Transactional Net Margin Method
-	Such other method as prescribed
Any other method, to be specified	Any other method, to be specified

Indian Transfer Pricing Regulations

Why is Transfer Pricing required ?

- The price charged by an enterprise to its group company may be
  - arbitrary;
  - dictated by either enterprise;
  - with no relation to cost incurred/ value added.
- Considering that the price can be charged as above, the taxable income of a group can be shifted from a high tax charging country to a low/ no tax charging country.
- Approximately 60% of the total transactions across the world are between related parties.

Provisions under Income Tax :

Act : Section 92 to Section 92F (+ penalty provisions)

Rules : Rule 10A to Rule 10E

Indian Transfer Pricing Regulations (Cont'd…)

Method	Remarks
CUP	Product/ service being compared have to be more or less similar to facilitate comparison
RPM	Less dependent on product comparison and largely dependent of the functions performed
CPM	Less dependent on product comparison and largely dependent of the functions performed
PSM	Useful in very complex and inter-related transactions, practical application is very limited and depends on detailed FAR. More relevant when there are multiple enterprises in the transaction chain
TNMM	Practically most preferred method for benchmarking

- References may be drawn from the Income Tax Act/ Rule for application of the above methods

Indian Transfer Pricing Regulations (Cont'd…)

Rule 10B(2) The comparability of the international transaction has to be judged with reference to the following:

(a) Specific characteristics of property transferred;

(b) FAR analysis;

(c) Contractual terms of the transaction;

(d) Conditions prevailing in the markets in which the respective parties to the transactions operate, including the **geographical location** and **size of the markets**, the **laws and government orders** in force, **costs of labour and capital in the markets**, overall economic development and **level of competition** and whether the markets are **wholesale or retail**.

Indian Transfer Pricing Regulations (Cont'd…)

The task is of finding the most reliable comparables and broadly following steps need to be followed:

- An understanding of economically significant relevant characteristics of the Controlled transactions
- Comparison between the conditions of the controlled transactions and conditions in transactions between independent enterprises taking place in similar circumstances

Comparable Uncontrolled Price Method (CUP)

Application of the CUP Method

- Identify price charged in comparable uncontrolled transaction;
- Adjust for differences materially affecting the price;
- The adjusted price is the ALP

Possible CUP scenarios

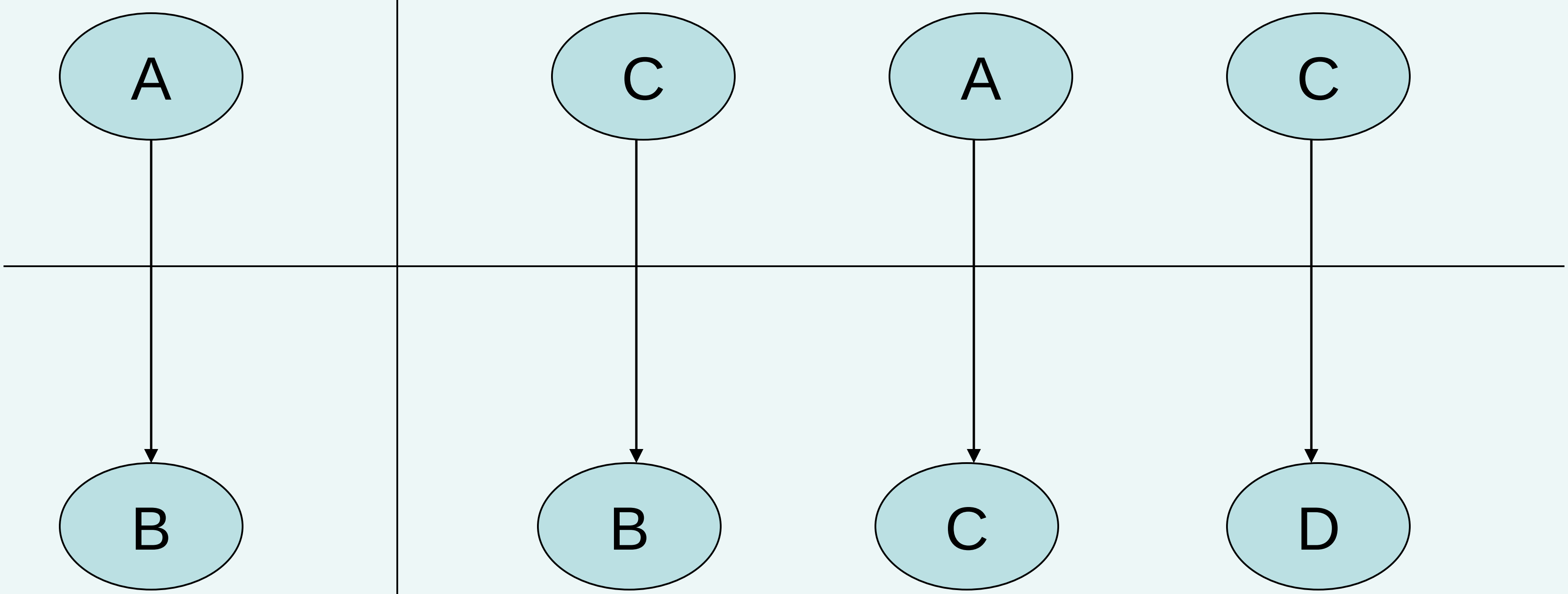
- Internal CUP - prices in any comparable dealing between the Company and an independent party; or
- Internal CUP - prices in any comparable dealing between the associated enterprises, who is a party to the transactions with the Company, and an independent party; or
- External CUP - prices in comparable dealings between two independent parties.

Comparable Uncontrolled Price Method (CUP) (Cont'd…)

A & B are Related Parties. C & D are independent Parties. Transaction of Sale of goods from A to B.

Controlled transaction **Uncontrolled Transactions**

Outside India



India

Comparable Uncontrolled Price Method (CUP) (Cont'd…)

- The CUP method is normally favoured to arrive at the arm's length price as it attempts to approximate the market price
- Ideally suitable for commodities that are subjects of frequent trade in the open market
- Considerations to be kept in mind while making the comparison:
  - Availability and reliability of the comparable data
  - Degree of comparability of the comparable data
  - The extent to which reliable and accurate adjustments can be made to account for differences
    - ✓ Delivery terms – Ex-works, FOB, CIF;
    - ✓ Contractual terms – differences in credit period;
    - ✓ Volumes of sales – discount % ?;
    - ✓ Timing of transaction;
    - ✓ Geographical location; etc.
  - Issue of value of intangibles included in the prices, eg. Branded items V/s non-branded items – Comparison of prices may not be appropriate.

Resale Price Method (RPM)

Application of the RP Method

- Identify the third party selling price for products purchased from Group Companies
- Reduce the comparable uncontrolled GP Margin in similar products
- Reduce the expenses incurred for procuring products/services
- Adjust for functional and other differences, if any
- The adjusted price is the ALP

Possible RPM scenarios

- Internal RPM – availability of gross margin earned by the Company from purchase from and sale to unrelated parties of similar products
- External RPM – availability of gross margin earned by a third party from purchase from and sale to unrelated parties of similar products

Resale Price Method (RPM) (Cont'd…)

Application of the RP Method

Particulars	Amount Rs.
Selling Price to third party	100
Arm's length Gross margin for similar product	10
Cost of Goods Sold	90
Costs in relation to procurement (Duties, freight, insurance, etc.)	20
Arm's length price – ALP **(A)**	70
Price charged by the related party **(B)**	65

In the above case, since price charged by the related party is **lower** than the ALP, the transaction is concluded to meet arm's length standards

Resale Price Method (RPM) (Cont'd…)

- This method is generally applied when the reseller does not add substantial value to the value of the product
- Characterisation of a low-end assembly operations – normally a manufacturer under Excise Law – may be treated as a distributor for transfer pricing purposes
- Product differences are more tolerable under the RPM as compared to the CUP method (eg. Reciprocating compressor with a Centrifugal compressor, the first one is a positive displacement compressor whereas the latter is a dynamic compressor)
- Accounting consistency is extremely important in applying the RPM (valuation of inventory; disclosures of discounts, insurance, transportation are considered as cost of goods sold or as operating expenses)
- Intangibles if present, would affect the gross margin earned
- Internal RPM should be applied carefully
- Adjustments as discussed under CUP method are applicable to RPM as well

Cost Plus Method (CPM)

Application of the Cost Plus Method

- Identify direct and indirect costs of production for goods
- Add uncontrolled normal GP mark-up
- Adjust for functional and other differences, if any
- The adjusted price is the ALP

Possible CPM scenarios

- Internal CPM – availability of gross margin earned by the Company from manufacture (purchases from third parties) and sale to third parties of similar products i.e. GP in an uncontrolled transaction
- External CPM – availability of gross margin earned by a third party by manufacture and sale to third parties

Cost Plus Method (CPM) (Cont'd…)

Application of the CPM

Particulars	**Amount Rs.**
Direct cost of production	100
Indirect cost of production	50
Total Cost of Production	150
Arm's length Gross margin for similar product (say 20%)	30
Arm's length price – ALP **(A)**	180
Price charged to the related party **(B)**	185

In the above case, since price charged to the related party **is higher** than the ALP, the transaction is concluded to meet arm's length standards

Cost Plus Method (CPM) (Cont'd…)

- This method is generally applied for manufacturing activities, assembling activity or relatively simple service providers
- This method is generally applied when the entity incurs low risks, because the level of costs will then better reflect the value being added and hence the market price. (contract manufacturers)
- The entity does not own product related intangibles
- Product differences are more tolerable under the CPM as compared to the CUP method
- Accounting consistency is extremely important in applying the CPM (valuation of inventory; method of depreciation - shifts; disclosures of discounts, insurance, transportation are considered as cost of goods sold or as operating expenses)
- Difference in level of utilisation of capacity between the Company and the comparables would also affect the ALP – Absorption costing method
- Internal CPM should applied carefully
- Adjustments as discussed under CUP method are applicable to RPM as well
- Practically not used as comparable GP information is not available from annual reports of comparable companies

Profit Split Method (PSM)

Application of the Profit Split Method

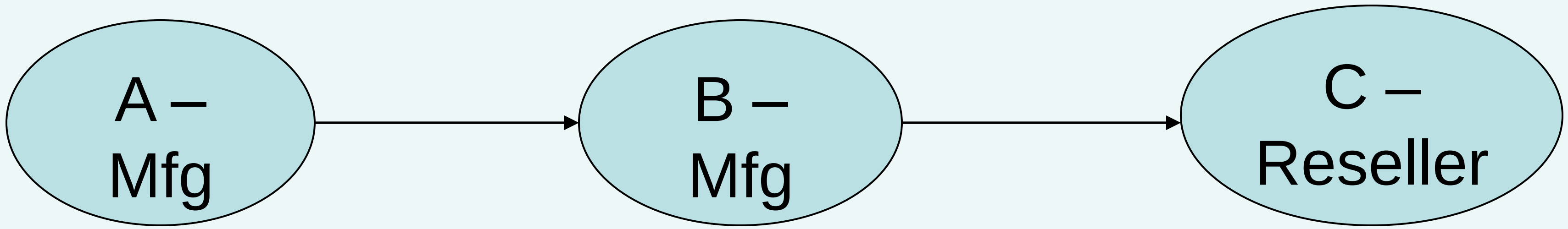
- Determine combined NP for Group from international transactions
- Evaluate relative contribution by each of the AEs based on the FAR
- Split the combined NP amongst the AEs proportionate to relative contributions
- The apportioned portion of the profit is taken to compute ALP

Possible PSM scenarios

A single stroke allocation method or a two-stage allocation approach may be followed. The two-stage allocation will result in first allocation of basic compensation for routine contributions and the second allocation will be based on the value of each enterprise's contributions of intangible property. The first allocation would require the use of the TNM Method for allocation of reasonable returns.

Profit Split Method (PSM) (Cont'd…)

- PSM is used in cases involving highly interrelated transactions that cannot be analysed on a separate basis
- Typically applied when both sides to the controlled transaction own valuable intangible property (eg. Patents, trademarks, trade names, etc.)



- A, B and C are related parties. A and B are manufacturing products using innovative technologies. C is a distribution company.
- In this case transaction between B & C may be concluded to be at ALP using the RPM. Now the combined profitability of A & B, needs to be distributed based on the value of their contribution. The basic

Profit Split Method (PSM) (Cont'd…)

remuneration without considering the effect of intangibles will have to be computed. This remuneration would be for the manufacturing function. The balance profit may be allocated with a reasonable allocation key; R&D expenses, capital employed, may be considered as a reasonable allocation key. The balance profit needs to be allocated keeping in mind the factors that bring about the combined profit and setting a relative weight to each factor.

PSM

[The OECD which is presently working on the BEPS project at the request of the G-20 countries, has specifically left the following items out of the definition of "Intangibles" viz., Location Savings, Assembled workforce and Group Synergies. Thus these specific items resulting in a cost saving/ higher profits should be allocated amongst both the entities (this will be more fact-driven).]

PSM is to be applied for a specific transaction or inter-related transactions, thus profit from other transactions need to be eliminated.

Profit Split Method (PSM) (Cont'd…)

- Getting financial information from the related party (especially foreign) is one of the most important challenge.
- Accounting practices and currencies need to be adjusted to make a meaningful comparison
- Practical application of this method is very difficult, especially the valuation of intangible and the remuneration for the intangible owned by each entity is very important.

Transactional Net Margin Method (TNMM)

Application of the TNMM

- Compute net margin for
  - costs incurred
  - sales effected
  - assets employed or
  - any other relevant base
- Compare net margin realised from comparable uncontrolled transaction
- Adjust for functional and other differences, if any
- The net margin is to be taken to compute ALP

Possible TNMM scenarios

The TNMM may be internal or external

Transactional Net Margin Method (TNMM) (Cont'd…)

- This is a commonly used method and preferred by tax authorities also as it protects the tax base erosion
- Net margins are less effected by transactional differences than price and less affected by functional differences than gross margin. Product and functional comparability are thus less critical in applying the TNMM
- Use of databases : Indian databases : PROWESS, CAPITALINE, etc.
- Tested party would be the one which has lesser risks
- Issues encountered in selection of comparables
  - Availability of data in public domain,
  - Different FAR of comparables,
  - Size of the comparables,
- Possible adjustments for comparability:
  - Working capital adjustment,
  - Risk adjustments, etc.

Transactional Net Margin Method (TNMM) (Cont'd…)

- Profit Level Indicator

PLI	Description	Typical Applicability
Operating Margin	Operating Profit/ Net Sales	Manufacturers Distributors
Return on Costs	Operating Profit/ Total Costs	Service providers Contract manufacturers
Return on Assets	OP/Operating Assets	Capital Intensive Manufacturers

- Issues of considering multiple year data to factor in the fact that entities may be at different product lifecyles and may face certain short term economic conditions
- Net margin from the related party transaction is to be computed and not an entity level net margin, this requires segmental profitability and also reasonable basis for allocation of costs amongst the segments

Transactional Net Margin Method (TNMM) (Cont'd…)

- Computation of operating margin i.e. exclusion of certain items of income and expense – interest income, dividend income, rental income, prior period income/ expenses, extraordinary expenses, foreign exchange gain/ loss, interest cost, etc.
- Indian TP regulations provide for the comparison based on arithmetical mean of the margin earned by comparable companies. For the FY 2014-15 a range of results would also be accepted, however, the Rules in this regard are not yet finalised by the CBDT.

Safe Harbour Rules

For instance –

- An entity is engaged in the manufacture and export of core or non-core auto components and where 90% of the turnover is in the nature of OEM sales.
- Core auto components defined as – engine and engine parts, including pistons and piston rings, engine valves and parts cooling systems and parts and power train components; transmission and steering parts, including gears, wheels, steering systems, axles and clutches; suspension and braking parts, including brake and brake assemblies, brake linings, shock absorbers and leaf springs"
- Non-core auto components – other than above
- Safe Harbour –
  - Core auto components - Operating margin to Operating Costs >= 12%
  - Non-core auto components - Operating margin to Operating Costs >= 8.5%

Safe Harbour Rules

Wherever safe harbour rules have been selected by the company, the same may act as a good basis for arriving at the conclusion of the normal price

Some Issues

Issues relating to comparability

- There is a complete lack of comparables in many segments

  Problem especially acute in developing countries where there are a number of 'sunrise' industries

- Result of this data paucity is not merely a lack of comparables but the serious consequence of using incorrect comparables

  Absurd comparables seem to get into the mix

  It often becomes a case of non-technical people trying to do technical work (example: choosing software verticals)

The whole comparability analysis exercise is at times unsound and indefensible at TP Assessments also

Some Issues (Cont'd…)

Date of filing the Cost Audit Report

- Cost Audit Report has to be issued by 30th September. However, getting comparable data from the publicly available database would pose certain challenges. Especially since financial data of comparable companies would be fairly available after the companies have completed their annual filings by the end of October

To counter this issue, from FY 2010-11, under the Income Tax the date of filing of return and the Transfer pricing Audit report was extended from 30-Sept to 30-Nov. **Thus the date of filing of the Cost Audit Report should essentially be aligned with the Transfer Pricing Audit Report.**

Should the normal price data not be available by the date of the **Cost Audit Report it may have to be qualified** since it requires the Cost Auditor to state "proper cost records as per section 148 have been maintained by the Company" and also has to state that "the said books and records <u>do not give the information required by the Companies Act 2013 in the manner so required</u>"

Some Issues (Cont'd…)

Use of the sixth method under Transfer Pricing

- In case the method used by the Company for benchmarking in the TP analysis is the sixth permitted method which is the applied using quotations obtained, etc. with no actual comparable transaction, the method to be selected in the Cost Audit Records

What if under transfer pricing the related party transactions are concluded to be not meeting arm's length standards

- The normal price to be given may have to be reworked. This is mathematical exercise. Rarely are suo-moto adjustments observed under transfer pricing where TNMM is used.

TNMM addition

Way Forward

The mechanism with which the Cost Audit Records are to be prepared has opened up a new area of practice. CMA's can add a lot of value in the area of transaction advisory services in relation to transfer pricing.

- Partial preparation of Transfer Pricing Analysis for the transaction covered by the Cost Audit Records
- Issuing audited segmental accounts to companies although AS-17 is not applicable, but are relevant for the Transfer Pricing Analysis/ Cost Audit Records
- Valuation of intangibles
- Need for more professionals in the field of transfer pricing

The BEPS project of the OECD should also be kept in mind which may bring in significant changes in the ways businesses would be structured in future. Since transfer pricing will need to be followed closely. For eg. Master file will reveal a lot of information, which may change the whole TP process carried out only by looking at the Indian operations (Contract manufacturing)

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THANK YOU