DRAFT COST ACCOUNTING STANDARD 6 ON
DETERMINATION OF ARM'S LENGTH PRICE

The following is the COST ACCOUNTING STANDARD 6 (CAS 6) issued by the Council of the Institute of Cost and Works Accountants of India on "Determination of Arm's Length Price ". The standard deals with the principles and methods of apportionment of determination of Arm's Length Price. In this standard, the standard portions have been set in bold italic type. These should be read in the context of the background material, which has been set in normal type.

1. Introduction

The sheer complexity of the determination of Arm's Length Price has made it a widely debated topic among the accounting professionals, with diverse views floating around. Traditionally Arm's Length Price is associated with transfer Pricing, which has been defined as the price at which goods are transferred from one division/department of an enterprise to another division/department of the same enterprise. With the passage of time the transactions between related parties have come to occupy the center stage on the issue of transfer pricing and consequently Arm's Length Price.

2. Objective

2.1 To bring uniformity in the principles to be followed in the determination and computation of Arm's Length Price.

2.2 To provide appropriate methodologies for determining Arms Length Price, for transactions between related parties.

2.3 ***To provide better transparency and disclosure in the ascertainment of the Arm's Length Price***.

3. Scope

3.1 ***The standard should be followed for determination of Arm's Length Price required to be carried out for any purpose or under provisions of any Act, Rules or Regulations except transactions includible intangibles where value has to be determined otherwise under any statute.***

3.2 This standard has to be read in conjunction with the earlier Cost Accounting Standards issued by the Council of the Institute of Cost and Works Accountants of India.

4.Definitions

Price: " Price" by definition is the rate at which a product/service is sold by a seller to the buyer. The legal definition of "price", in relation to the sale of any goods or to the performance of any services, includes every valuable consideration, whether direct or indirect, or deferred, and includes any consideration which in effect relates to the sale of any goods or to the performance of any services although ostensibly relating to any other matter or thing;

***Market Price*: It is the Price, which is determined by the interaction of various forces in the market.**

Explanation: Sometimes, the Government may also intervene to fix a 'fair price' or 'controlled price' or a 'subsidized price'.

***Transfer Price (TP)*: Transfer Price is an 'internal price' which can be fixed by the management of an enterprise or group of enterprises for transfer of products and services intra enterprise/group/related parties who may be in a position have "undue influence" to intervene in the process of fixing the price.**

***Undue influence*: Parties who may be in a position to intervene in the process of fixing the transfer price, as above, may intervene in a manner so as to lead to an advantage or disadvantage to the transferor or transfereeSuch Intervention can be termed as undue influence on the price**

***Arms Length Price (ALP)* : means the price, which is applied in a transaction between persons other than related parties in uncontrolled conditions.**

Explanation: This means that this is a 'fair price' – fair and reasonable to both transferor and transferee. ALP is the TP based on some logical methods, which have been modified by various tax legislations in the country under Income tax, Customs, Excise and sales tax, etc., as per the cannons of taxation.

(Proper Corporate Governance demands that the TP is fixed based on generally accepted principles in order to ensure that there is an element of fairness in the financial results and financial position of the enterprise).

***Related parties*: In the context of a company, parties connected to the common through relation with directors and persons having substantial controlling interest in the company, companies under the same management and subsidiaries. In particular, in the context of a company it means an entity: a) which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of such company or vice versa; or b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital of such company or vice versa.**

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An entity (which includes an individual, a Hindu Undivided Family, a partnership firm, an association of persons, a trust or a company) shall be deemed to be a related party in relation to a company if, at any time during the previous year: a) the entity holds, directly or indirectly, shares carrying not less than twenty-six percent of the voting power in such company or vice versa: or b) any person or entity holds, directly or indirectly, shares carrying not less than twenty-six percent of the voting power in each of the entities: or c) a long advanced by the entity to the company constitutes not less than fifty-one per cent of the book value of the total assets of the company or vice versa: or d) the entity guarantees not less than fifty-one per cent of the total borrowings of the company or vice versa: or e) more

than half of the board of directors or members of the governing board, or one or more executive members of the governing board of the entity, are appointed by the company or vice versa: or f) more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the entity and the company are appointed by the same person or persons: or g) the manufacture or processing of goods or articles or business carried out by the entity is wholly dependent on the use of know how, patients, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the company is the owner or in respect of which the company has exclusive eights or vice versa: or h) ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by the entity, are supplied by the company, or by persons specified by the company, and the prices and other conditions relating to the supply are influenced by such company or vice versa: or i)the goods or articles manufactured or processed by the entity , are sold/transferred to the company or to persons specified by the company, and the prices and other conditions relating thereto are influenced by such company or vice versa: or j)where the entity is controlled by an individual, the other company is also controlled by such individual or his relative or jointly by such individual and relative of such individual: or k) where an entity has the power to direct, by statute or agreement, the financial and operating policies of the company or vice versa: l) there exists between two entities, any relationship of mutual interest as may be prescribed provided one of them is a company.

<u>Tangible Transactions</u> refer to Transactions involving physical goods or services.
<u>Intangible Transactions</u> refer to the transactions having intellectual content like inventions, patents, design, trademark, franchises, licenses, brand, know-how, etc.

<u>5. Methods of Computation of ALP</u>

The following methods may be adopted for determination of Arm's Length Price, having regard to the nature of transaction or class of transactions.

I. For Tangible Transactions.

1. ***Comparable Uncontrolled Price Method (CUP)***
2. ***Resale Price Method***
3. ***Cost Plus Method***
4. ***Profit Split Method***
5. ***Transactional Net Margin***

II. For Intangible Transactions (Method described later).

5.1 COMPARABLE UNCONTROLLED PRICE METHOD

The price charged or paid in a comparable uncontrolled transaction or a number of such transactions shall be identified. Such prices shall be adjusted to account for differences, if any, between the related party transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market. The adjusted price shall be taken as arm's length price. The uncontrolled transaction means a transaction between independent enterprises other than related parties and shall cover goods or services of a similar type, quality and quantity as those between the related parties and relate to transactions taking place at a similar time and stage in the production/distribution change with similar terms and conditions applying.

5.2 RESALE PRICE METHOD

The price at which the goods purchased/service obtained from a related party is resold or is provided to an unrelated entity shall be identified. Such resale price shall be reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar goods or services in a comparable uncontrolled transaction or a number of such transactions. The price so arrived at shall be further reduced by the expenses incurred by the enterprise in connection with the purchase of goods or services. Such price shall be further adjusted to take into account the functional and other differences including differences in accounting practices, if any, between the related party transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market. The adjusted price shall be taken as arm's length price in respect of goods purchased or services obtained from the related party.

Applicability: The resale price method would normally be adopted where the seller adds relatively little or no value to the product or where there is little or no value addition by the reseller prior to the resale of the finished products or other goods acquired from related parties. This method is often used when goods are transferred between related parties before sale to the independent party.

5.3 COST PLUS METHOD

The total cost of production incurred by the enterprise in respect of goods transferred or services provided to a related party shall be determined. The amount of a normal gross profit mark-up to such costs arising from the transfer of same or similar goods or services by the enterprise or by an unrelated enterprise in a comparable uncontrolled transaction or a number of such transactions, shall be determined. The amount of a normal gross profit mark-up shall be adjusted to take into account the functional and other differences, if any, between the related party transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market. The total cost of production referred to above increased by the adjusted profit mark-up shall be taken as arm's length price. It is also important here to

ensure that the cost base to which mark-up is applied is comparable to the cost base of the third party transaction which serve as comparable. For example, it may be necessary to make an adjustment to cost where one person leases its business assets while other owns its business assets.

Applicability: The cost plus method would normally be adopted if CUP method or resale price method cannot be applied to a specific transaction or where goods are sold between associates at such stage where uncontrolled price is not available or where there are long term buy and supply arrangements or in the case of provision of services or contract manufacturing.

5.4 PROFIT SPLIT METHOD

The combined net profit of the related parties arising from a transaction in which they are engaged shall be determined. This combined net profit shall be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of transaction in which it is engaged with reference to market returns achieved for similar types transactions by independent enterprises. The residual net profit, thereafter, shall be split amongst the related parties in proportion to their relative contribution to the combined net profit. This relative contribution of the related parties shall be evaluated on the basis of function performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances. The combined net profit will then be split amongst the enterprises in proportion to their relative contributions. The profit so apportioned shall be taken into account to arrive at an arm's length price.

Applicability: This method would normally be adopted in those transactions where integrated services are provided by more than one enterprise or in the case multiple inter-related transactions, which cannot be separately evaluated.

5.5 TRANSACTIONAL NET MARGIN METHOD

The net profit margin realized by the enterprise from a related party transaction shall be computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base. The net profit margin realized by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions, shall also be computed having regard to same base. This net profit margin shall be adjusted to take into account the differences, if any, between the related party transaction and the comparable uncontrolled transactions or

between the enterprises entering into such transactions, which would materially affect such net profit margin in the open market. The cost of production referred to above increased by the adjusted profit mark-up shall be taken as arm's length price.

Applicability: This method would normally be adopted in the case of transfer of semi-finished goods; distribution of finished products where resale price method cannot be adequately applied; and transaction involving provision of services.

6. TRANSFER PRICE FOR INTANGIBLES

Intangibles refer to the property having intellectual content like inventions, patents, design, trademark, franchises, licenses, brand, etc.

The intangibles are classified as

- ***Trade***
- ***Market***

Trade intangibles are created out of Research & Development like know-how, designs, etc. There can be 3 types of such arrangements.

- ***One enterprise does research and keeps the property rights.***
- ***One enterprise carries on research on behalf of other members as per a contract.***
- ***One enterprise carries on research on behalf of the group engaged in a common activity and all share the ownership.***

Market intangibles are trade names (brands including symbols, pictures, etc.). This again can be owned by one enterprise or shared with others. Brand valuation should be done taking into account all the variables like quality control and R&D, availability, success of promotion expenses, value of the market, etc.

ALP is applicable for intangibles. It is a difficult exercise and it is difficult to establish or prescribe any standard or guidelines for the legal and economic ownership of the marketing intangible.

ALP for Intangibles:

The utility of the property is an important criterion while determining comparability of intangible properties.

The following aspects should be given proper weightage while applying the Arm's length principles.

- ***Area of right***
- ***Export restriction***
- ***Nature of right (exclusive or non-exclusive)***
- ***Capital investment***
- ***New or special machinery***
- ***Start-up expenses/ development work required in the market***
- ***Possibility of sub-licensing***
- ***Licensee's right for participation in further development of property by licensor.***

For intangibles, CUP or Resale Price method would be appropriate. Where transfer of highly valuable intangible is involved profit based method (Profit split method or Transactional Net Margin method) is more appropriate.

7.0 PRESENTATION AND DISCLOSURE

7.1 ***The method of determination of Arm's Length Price should be properly disclosed. If there is any change in the method of determination of Arm's Length Price, such change and the effect of such change should be disclosed, along with reasons for such change.***

7.2 ***Where, the enterprise follows policies and methods that are different from that prescribed under this cost accounting standard, policies, methods, rationale and circumstances for adopting such methods should be disclosed.***

7.3 ***If there is any statutory requirement for a particular industry on the method of determination of Arm's Length Price , proper disclosure about the method prescribed should be annexed to the cost statements.***

Annexure 1: Comparable Uncontrolled Price Method (CUP) illustrated

Arms Length Price – Comparable Uncontrolled Price Method (CUP) MANUFACTURING SECTOR

Example 1:

XYZ of Japan sells to ABC of India (related) and to MNO of UK (unrelated) its CD players. The product is identical. The terms are one-year warranty for India and 6 months warranty for UK. The cost of one-year services is estimated as Rs.500/- per piece in India and UK. Sales to ABC is CIF and to MNO is FOB. As the products are identical, warranty and insurance and freight will have to be normalised for comparison of both the prices. We have to determine the ALP on CUP basis for sales from XYZ to ABC.

Calculation:

Particulars	XYZ to ABC Rs.	XYZ to MNO Rs.
Selling Price (converted to Rs.on the date of invoices for ABC)	5000.00	4000.00
Less: Cost of service	500.00	250.00
	4500.00	3750.00
Add: Insurance & freight (actual)	Nil	250.00
Normal comparable price	4500.00	4000.00

No. of pieces purchased by ABC	10000
Arm's Length Price	Rs.4000/-
Transfer price charged to ABC	Rs.4500/-
Excess TP charged per piece	Rs.500/-
Total excess income of ABC under CUP method	Rs.50 lakhs

Arms Length Price – Comparable Uncontrolled Method (CUP) SERVICES SECTOR FINANCIAL

<u>Example 2:</u>

A Ltd. a bank promotes B Ltd. a merchant banking subsidiary jointly with a foreign collaborator. B Ltd. wants a loan from A Ltd. at the Prime Lending Rate (PLR) of A Ltd. A Ltd. normally lends at PLR to its borrowers having the highest credit rating score as per its internal rating score. B Ltd. being a new company does not have the highest score but will qualify as "Average" if credit rated. The foreign collaborator is a company having an excellent credit score. The foreign collaborator offers to give a guarantee to B Ltd.'s borrowing from A Ltd. or any other bank.

<u>A Ltd.: Details</u>

Rate of interest charged to B Ltd. (Through out the year)		10% p.a.
Frequency		Quarterly interval
PLR charged by A Ltd to 'A+' customers (rate charged during the mid year)		10% p.a. for 6 months 12% p.a. for 6 months
Average PLR		11% p.a. (weighted average for the period)
Credit rating of B Ltd. as per internal score		Average
Lending rate of A Ltd to "average" borrowers		11% p.a. for 6 months 13% p.a. for 6 months
Average Lending Rate of A Ltd for "Average" Rated Borrowers		12% p.a. (weighted)
PLR of Bank 'C Ltd.' (independent) Average for the year		11.5% p.a.
PLR of Bank 'C Ltd.' charged out of pocket expenses, Cost of inspection, etc. for all corporates		0.5% p.a.
Total interest costs charged by A Ltd. for B Ltd.		Rs.5 lakhs p.a.
Out of pocket expenses recover by A Ltd. from B Ltd.		Nil
<u>Comparable Uncontrolled Price</u>	A Ltd. To B Ltd. (Related party)	Other Bank
Interest rate applied Add: Out of pocket expenses	10% p.a. Nil	11.5% p.a. 1.0% p.a.
Effective Rate	10% p.a.	12% p.a.
Transfer Price advantage passed to 'B Ltd.'	2% p.a.	
However, ARMS LENGTH PRICE is PLR charged by A Ltd. for all other "Average" customers (unrelated)		12% p.a.
Transfer Price advantage as per CUP		2% p.a.
Actual interest paid		Rs.5,00,000/-
Transfer price advantage passed to B Ltd. @ 2% as per CUP - 5,00,000 x 2/10		Rs.1,00,000/-
Interest earning of A Ltd. as per CUP		Rs.6,00,000/-

Annexure 2: Resale Price Method illustrated

Arms Length Price under Resale Price Method --- physical goods-

This method is ideally used for enterprises doing only marketing, sales and distribution functions with an insignificant value addition.

Example 1:

UK Company ‘A’ sells a cosmetic perfume to its related enterprise ‘B’ at Rs.60/- per piece. ‘B’ resells to unrelated parties at Rs.100/-. The total cost of the product to ‘B’ is Rs.80/- including administration and selling and distribution cost of Rs.20 per piece. In this trade, the normal gross margin is 25%.

ALP is resale price Rs.100/- less Gross Profit Rs.25	–	Rs.75	
Less: Costs incurred for administration	-	Rs.20	
ALP per unit		-	Rs.55

The Transfer Price of Rs.60/- under controlled condition is in excess by Rs.5/- per unit reducing the profit of ‘B’ causing revenue leakage to the country.

Here, the costs incurred for unrelated parties require proper analysis and record. The CAS-1 6.3.5 to 6.3.9 should be applied for determining the cost of administration, selling and distribution. It may be noted that the resale price method does not envisage incurring of costs under the head ‘Research & Development’.

Example 2:

X Ltd. markets imported Injection sets of insulin

Imports are made from A Ltd. (Related enterprise) and B Ltd. (Unrelated enterprise)

Additional Information available:

1. A Ltd.’s supplies are in 100’s packs on CIF basis (Insurance Rs.2,00,000/- for 1,00,000 units and freight Rs.5,00,000/- for 2,00,000 units)
2. B Ltd.’s supplies are in 50’s packs on FOB basis
3. A Ltd.’s supplies are at Rs.15,000/- per pack of 100’s
4. B Ltd.’s supplies are at Rs.6,000/- per pack of 50’s
5. Actual freight incurred for supplies from B Ltd. – Rs.50,000/- for 10000 packs
6. Actual insurance incurred for supplies from B Ltd. – Rs.30,000/- for 10000 packs
7. Actual purchases by X Ltd. during the year - 25000 packs from A Ltd.
   - 10000 packs from B Ltd.
8. Costs incurred by X Ltd. for the year

Rent of premises		Rs.60,000/-
Office expenses	Rs.50,000/-	
Wages paid for repacking		Rs.1,50,000/-
Packing materials for repacking		Rs,1,50,000/-
Freight and Insurance outward		Rs.30,000/-
Free samples for marketing		Rs.50,000/-
Wastage (broken) not allowed by Insurance	Rs.5,000/-	

9. Selling Price Rs.200/- per unit
10. All the units purchased are sold in the same year and no stock is left (If stocks are left they should be valued at cost excluding selling and distribution overheads)

Computation of ALP under Resale Price Method

Particulars	From A Ltd.	From B Ltd.	Total
No. of units purchased & sold	25,00,000	5,00,000	30,00,000
Resale price per unit	Rs.200/-	Rs.200/-	Rs.200/-
Sales value (Rs. In lakhs)	5000.00	1000.00	6000.00
<u>Costs incurred</u> (Rs. In lakhs)			
Purchases	3750.00	600.00	4350.00
Freight	Nil	0.50	0.50
Insurance	Nil	0.30	0.30
<u>Administrative expenses</u> Rent Rs.60,000/- Office Exp. Rs.50,000/- Total Rs.1,10,000/- (distributed in the proportion of Net Sales Value as per IAS 7.2)	0.92	0.18	1.10
<u>Selling Costs</u> Repacking materials 1,50,000 Wages for repacking 1,50,000 Freight & Insurance 30,000 Free samples 50,000 Wastage 5,000 Total 3,85,000 (distributed based on Net Sales Value as per IAS 7.2)	3.21	0.64	3.85
TOTAL COSTS	3754.13	601.62	4355.75
GROSS PROFIT	1245.87	398.38	1644.25
GROSS PROFIT % on SALES	24.92	39.83	
Independent Enterprise GP %		**39.83**	

<u>ALM Calculation:</u>

Resale Price of X Ltd. for purchases from A Ltd. (related) per unit Rs.200.00

Total sales of purchased from A Ltd. (25000X100X200) Rs.5000.00 lakhs

Less: Normal Gross Profit on independent transaction @39.83%Rs.1991.50 lakhs

Normal Cost of Sales Rs.3008.50 lakhs

Less: Other specific costs

Administration cost Rs.0.92

Selling costs	Rs.3.21	
Total		Rs. 4.13 lakhs
Purchase Cost as per Resale Price method For purchases from A Ltd.	Rs.3004.37 lakhs	
ALM Purchase cost per pack of 100's(Rs.3004.37 lakhs ÷ 25000)	Rs.12,017.48	
Actual Purchase cost per pack of 100's	Rs.15,000.00	
Extra purchase cost per pack paid to A Ltd. there by making X Ltd. to suffer a disadvantage	Rs.2,982.52	
Income additionally chargeable to X Ltd. as per Transfer Price Margin in Resale Price Method (i.e. loss of income to X Ltd. and undue benefit passed on to A Ltd. due to related party transaction)	Rs.745.63 lakhs	

Annexure 3: Arms Length Price under Cost Plus Method illustrated

Arms Length Price under Cost Plus Method-manufacturing

This method is useful in case of services, transfer of goods requiring further processing or long-term agreements for buying / selling are applicable.

Explanation: If ABC Ltd. is transferring goods/services to XYZ Ltd., a related enterprise, the total costs incurred by ABC Ltd. are determined.

If similar/same goods are or services are transferred to unrelated parties or such transfer is done by an unrelated enterprise in comparable uncontrolled transaction, the normal Gross Profit Mark-up to costs will be determined. The normal GP Mark-up will be adjusted for the differences materially affecting such profit mark-up in the open market.

ALP = Total cost of production + Adjusted Gross Profit Mark-up.

Here, cost bases are to be comparable in both transactions. An adjustment to costs may be necessary to make it comparable.

Costs may be classified as per CAS 1, 2, 3 & 4

Illustration:	ABC Ltd. transfers goods to	
	XYZ Ltd. (Related party) Rs./unit	MN Ltd. (Comparable transaction) Rs./unit
Direct Material	10.00	10.00
Direct Wages	15.00	15.00
Direct Expenses	10.00	10.00
Prime Cost	35.00	35.00
Factory Overheads	5.00	5.00
Administrative Overheads	3.00	3.00
Cost of Production	43.00	43.00

Gross Profit Mark-up	8.60 (@ 20%)	17.20 (@ 40%)
Selling Price	51.60	60.20
Gross Profit Mark-up %	20%	40%
Gross Profit Mark-up	8.60	17.20
Less: Selling costs	Nil	1.40
Less: Distribution costs	4.20	2.00
Adjusted GP Margin	4.40	13.80
Adjusted GP Margin % on cost	10.23%	32.09%
Adjusted GP Margin (comparable independent)		32.09%
Adjusted GP Margin (actual)		10.23%
Difference in GP Margin		21.86%
Actual cost of production per unit		Rs.43.00
Increased GP per unit		Rs.9.40
Actual selling price		Rs.51.60
Arms Length Price per unit		Rs.61.00
Actual revenue booked for XYZ Ltd. (50000 x 51.60)		Rs.25,80,000/-
Sales at ALP (50000 x 61.00)		Rs.30,50,000/-
Increased income as per ALP under Cost Plus Method		Rs.4,70,000/-

Annexure 4: Arms Length Price under Profit Split Method illustrated

Arms Length Price under Profit Split Method

This method is suitable for those transactions where integrated services are provided by more than one enterprise or in case of multiple inter related transactions which cannot be separately evaluated. It is necessary to identify the total profit and split it based on the activities performed assets employed and risks assumed by each party with a comparison of valuation of such activities done by unrelated enterprises on a comparable basis.

Illustration (services sector)

A Ltd. and B Ltd. (related parties) jointly do an assignment of **computerisation** together with an unrelated party C Ltd. A Ltd. is the main contractor and B Ltd. and C Ltd. are the sub-contractors. A Ltd. supplies all hardware and B Ltd. supplies a portion of the software and C Ltd. supplies another portion of the software.

The total gross earnings received by A Ltd. is Rs.100 lakhs and it pays Rs.10 lakhs to B Ltd. and Rs.20 lakhs to C Ltd. This has to be adjusted to calculate the Arms Length Price from A Ltd. to B Ltd. Under this situation Profit Split Method could be adopted.

The total profit earned by A Ltd. and B Ltd. in this transaction is determined as follows:

	A Ltd.	B Ltd.	C Ltd.	Total

Earnings (Rs. in lakhs)	70.00	10.00	20.00	100.00
Costs (Direct+Indirect as per CAS-4) Rs. in lakhs	30.00	7.00	10.00	47.00
Profits before ALP	40.00	3.00	10.00	53.00
Return on costs in %	133%	43%	100%	
Basic Return (Surplus to be split)	6.00 @ 20%	7.00 @ 100%	10.00 @ 100%	23.00
Surplus return to be shared				30.00
Share of contribution for the Job	50%	25%	25%	
Surplus return distributed in the ratio of share of contribution to the job	15.00	7.50	7.50	30.00
Total share of surplus	21.00	14.50	17.50	53.00
ALP from A Ltd. to B Ltd.		21.00		
Actual earnings for B Ltd.		10.00		
Additional revenue as per ALP		11.00		

Here assuming the C Ltd. transaction is more or less similar and comparable, the return of 100% on costs may be applied to find out the ALP for B Ltd.'s transaction with A Ltd.

This method has a limitation as to availability of the costs/revenue from the main contractor to ascertain the overall profits, etc. Because of this limitation, this method is not widely used.

A normal return for each industry/task may have to be determined involving detailed backup for each assumption. Collection of cost input details for each job/transaction as prescribed under CAS 1 to 4 will be helpful giving proper backup for the assumptions on cost inputs, capital employed, risks assumed etc. to determine the relative contribution.

Illustration 2:

				(Rs. In lakhs)	
Total Earnings	In a Contract			100.00	
Share of:	A Ltd.			70.00	
	B Ltd.			10.00	
	C Ltd.			20.00	
Costs:	A Ltd.			30.00	X_1
	B Ltd.			7.00	X_2
	C Ltd.			10.00	X_3
	Total			47.00	$\sum X$
Normal Return on Costs:*		A Ltd.	30%	9.00	Y_1
		B Ltd.	20%	1.40	Y_2

	C Ltd.	20%		2.00	Y_3
	Total			12.40	$\sum Y$
Costs + Normal return			59.40 $\sum X + \sum Y$		
Excess surplus (Total Earnings – Costs – Normal Return)			40.60		
Excess surplus distributed in the ratio of costs incurred:					
	A Ltd.	40.60 x 30/47	25.91		
	B Ltd.	40.60 x 7/47	6.05		
	C Ltd.	40.60 x 10/47	8.64		
Aggregate Profits:	A Ltd.			34.91	
	B Ltd.			7.45	
	C Ltd.			10.64	
Earnings based on ALP:	A Ltd.		64.91		
	B Ltd.			14.45	
	C Ltd.			20.64	
ALP for B Ltd.:	ALP Earnings		14.45		
	Actual Earnings		10.00		
Excess to be recognised as Earnings under ALP thru profit split method				**4.45**	

Annexure 5: Transactional Net Margin Method (TNMM) illustrated

Arms Length Price – Transactional Net Margin Method (TNMM)-services sector

This method suits for transfer of semi-finished goods and distribution of certain services where the resale price method is difficult to apply.

Illustration:

A Ltd. is an international bank engaging B Ltd. a related party for call centre services. B Ltd. also does call centre services for other banks. According to this method, the net margin for related party and comparable unrelated party should be arrived at. The net margin could be based on the total costs incurred, capital employed, number of man-hours spent for each bank by MIS, etc. A weighted return could be arrived at as under:

Facts of the case:

			(Rs. In lakhs)
Total Fixed Assets employed (Gross value) (Building on Rent)		100.00	
Risks involved: Obsolescence Fire Loss of life, etc.			

Of the above, obsolescence is the high risk factor requiring the Fixed Assets to be fully recovered in 2 years.

Therefore, return expected on Fixed Assets is 100%, i.e. 50% for costs excluding depreciation and profit and 50% for depreciation.		100.00	
No. of persons employed (3 shifts – 24 hrs.)	200		
Maximum human hours 200 x 6 x 365 per year	4,38,000		
Salary & Perks costs per person	Rs.20,000/-		
Total salary costs per year			40.00
Other costs: Rent (Rs.1,00,000/- p.m.)	12.00		
Insurance	5.00		
Electricity	10.00		
Local taxes	2.50		
Other expenses (transport, etc.)	5.00		
Total			34.50
Total Weighted Costs		**174.50**	
Total Revenue billed		**300.00**	
Net Margin (Aggregate)			**125.50**
Net Margin % on weighted costs		**71.92%**	

Activity spread: (No. of calls attended)

A Ltd. (related party)	5000
X Bank (unrelated)	2000
Y Bank (unrelated)	2500
Z Bank (unrelated)	3000
Total	12500

Billing: (Rs. in lakhs)

A Ltd. (related party)	100.00
X Bank (unrelated)	60.00
Y Bank (unrelated)	70.00
Z Bank (unrelated)	70.00
Total	300.00

Total costs distributed to customers on Activity basis:

A Ltd. (related party)	69.80
X Bank (unrelated)	27.92
Y Bank (unrelated)	34.90
Z Bank (unrelated)	41.88
Total	174.50

Net Margin (Billing minus distributed costs):

A Ltd. (related party)	30.20
X Bank (unrelated)	32.08
Y Bank (unrelated)	35.10
Z Bank (unrelated)	28.12
Total	125.50

Net Margin % on distributed costs:

A Ltd. 3020/6980 x 100 43.27%

Comparable (X, Y & Z) 95.30/104.70 x 100 91.02%

Applying the comparable Net Margin of 91.02% on the costs
incurred in respect of A Ltd.

	A Ltd. costs		69.80
Add:	Net Margin @ 91.02%	63.53	
	Total		133.33

Arms Length Price (Earning) **133.33**

Actual Billing	**100.00**
Excess to be taken as income for B Ltd.	
Based on the ALP	**33.33**
Under Transactional Net Margin Method	