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- Why do a FAR Analysis
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- Key Factors in FAR Analysis
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- Economic Analysis
- Key Takeaways
What is Functions, Assets and Risk (‘FAR’) analysis
What is FAR Analysis

- FAR Analysis is an exercise to determine and document significant economic activities performed by the enterprise and its associated enterprise (‘AEs’) in an International Transaction.

- Allocation of significant economic activities between those entities involved in the transaction, so each entity can be appropriately characterised.

- **Price charged** in any transaction should reflect the functions performed (taking into account the risks assumed and assets used).

FAR Analysis → Characterization → Pricing of the transaction
 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...

**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
Risks 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
Why do a FAR analysis – Regulations Perspective

1. **Rule 10B(2)** of the Income Tax Rules, 1962 asserts on **Importance of FAR Analysis:**

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

   i. Functions performed, taking into account assets employed and risks assumed, by both the parties to the transactions

   ii. 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

2. Para 1.36 (Chapter 1) 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”
• To **identify an appropriate reward** that each of the related parties should earn with respect to intercompany transactions under review

• To **determine the economic characterization** of the entities in the transaction and to **select a tested party**

• To **determine** the **most appropriate method** for benchmarking the transaction

• To **identify any uncontrolled transaction** involving one of the controlled parties

Detailed FAR analysis provides **in-depth understanding** of the business and assists in appropriate characterization of an entity
How to do a FAR analysis
Inputs of FAR Analysis

- Markets / Competition
- Business Processes
- Forecasts / Business Plans
- FAR Analysis
- Entities / Transactions
- Organization / Staff
- Functions, Assets & Risks
- Agreements / Terms
- Financial Results
Outputs of FAR Analysis

- Internal Comparables
- Basis to search for external comparables
- Risk and opportunity assessment
- Determination of most appropriate method
- Characterization of entities
- Documentation
- Pricing Policy
- Understanding of Business
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 & identify interview contacts
- Create detailed FAR questionnaire
- Conduct Interviews and make notes

**FAR Documentation**
- Summarizing FAR findings in the documentation report
Functional analysis – Process Flow

Organization Structure
- Pharma MNC
- Entities in US, UK, India and China

Activities
- US – Strategy and Marketing
- UK – Marketing
- India – R&D
- China – Manufacturing

Functions
- US – Identifies products, lays business strategy, budgets and forecasts, gets regulatory clearances, markets and sells
- UK – Gets regulatory clearances, markets and sells
- India – Conducts R&D, sells
- China – Manufactures and sells
Fact Finding process...

Gathering basic information
- Background information about the enterprise to understand its business operations and activities – (Sources: Annual Report, Product brochures, Websites, internal reports)
- Description of the ownership structure of the enterprise
- Profile of multinational group of which the enterprise is a part
- Broad description of the business of the enterprise
- Broad description of the industry to which the enterprise belongs

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, agreement, correspondence / communication between the parties)

Gathering relevant documents
- Agreements, common group policies etc.
- Product brochures, marketing materials etc.
- Documents providing information such as marketing strategies, pricing strategies etc.
- Information about major competitors, customers, market, etc.
Below are certain important questions for FAR analysis of a Distributor

• Who is responsible for market surveys? Who monitors market demand?
• Who is responsible for devising advertising and promotion strategies? Who formulates the budget? Who bears the costs?
• Who is responsible for scheduling the distribution of the products in the market? Who is responsible for holding the inventories on hand?
• Who determines the product pricing? Do these require approval from the manufacturer/principal distributor?
• Is there an existing distribution network or the distributor is engaged in developing a distribution network for the product?
• Who owns the intangibles in the products distributed? Who undertakes the DEMPE functions in relation to the brand?
• Is there a need for installation and after-sales services? Who is responsible for providing these services?
• Who formulates warranty policies? Who bears the warranty costs?
• Who bears the risk on account of bad debts?
• Who would bear the risk in case the product does not perform as per standards?
• Who takes title of the merchandise distributed?
Key Factors in FAR Analysis
Key Factors in FAR analysis

- Sheer volume of functions performed is **not decisive** - What is relevant is the **relative importance of each function**
- Functions performed may be few but significant
- Identify **each party’s contribution (Taxpayer & AE)** to every function performed
- Functions are the **terra firma** for identifying and assigning risks to an entity
- Aggregation of International Transactions - **only if FAR analysis of such transactions is aligned**
OECD Guidelines – Importance of FAR analysis
Section D of Chapter I of the OECD Guidelines, 2017 states:

- Accurately delineate the actual transactions by analyzing the contractual relations together with evidence of the actual conduct of the parties
- Detailed guidance on analyzing risks as integral part of a functional analysis, including six step analytical framework
- Party assuming risk should control the risk and have the financial capacity to assume the risk
- Capital-rich MNE group member without any other relevant economic activities (“cash boxes”) that provides funding, but cannot control financial risks in relation to the funding, will attain no more than a risk-free return, or less if the transaction is commercially irrational

Shift focus from the legal form to the economic reality of a transaction
Six-step analytical framework

1. Identification of economically significant risks

2. Determination of contractual assumption of the specific risk

3. Functional analysis in relation to risk

4. Interpreting steps 1-3

5. Allocation of risk

6. Pricing the transactions taking into account the allocation of risks

If AE (contractually) assuming the risk does not exercise control over the risk or does not have the financial capacity to assume the risk, then risk should be allocated to enterprise exercising control and having financial capacity to assume risk.
FAR Analysis of Intangibles
FAR Analysis of Intangibles

1. Identify the intangibles used or transferred in the transaction

2. Identify the full contractual arrangements, with special emphasis on determining legal ownership of intangibles

3. Detailed functional analysis (DEMPE functions, assets and risks)

4. Confirm consistency between the terms of the contractual arrangements and the conduct of the parties (focus on DEMPE functions and risks, etc.)

5. Determine arm’s length prices for contributions

- Allocation of returns from the exploitation of intangibles should especially be based on which parties perform the DEMPE functions, assume the risks and provide funds or other assets
- Legal ownership becomes less important
DEMPE Functions are the key

Development > Enhancement > Maintenance > Protection > Exploitation
Case Studies
## Typical FAR of Manufacturers

<table>
<thead>
<tr>
<th>Functions and Assets</th>
<th>Full Fledge</th>
<th>Licensed</th>
<th>Contract</th>
<th>Toll</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owns non-routine technology i.e. IP (R &amp; D)</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Owns Material</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Manufactures for himself</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manufactures on behalf of others</td>
<td></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Marketing</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Sales &amp; Distribution</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Risk</th>
<th>Normal</th>
<th>Less than Normal</th>
<th>Limited</th>
<th>Minimal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Risk</td>
<td>Yes</td>
<td>Yes</td>
<td>N(Minimal)</td>
<td>N(Minimal)</td>
</tr>
<tr>
<td>Price Risk</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Inventory Risk</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Capacity Risk</td>
<td>Yes</td>
<td>Yes</td>
<td>Limited</td>
<td>No</td>
</tr>
<tr>
<td>Product Liability Risk</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Warranty Risk</td>
<td>Yes</td>
<td>Yes</td>
<td>Limited to re-work</td>
<td>Limited to re-work</td>
</tr>
<tr>
<td>Technology R &amp; D Risk</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>
## Typical FAR of Distributors

<table>
<thead>
<tr>
<th>FAR</th>
<th>Functions and Assets</th>
<th>Types of Distributor</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>Marketer Distributor</strong></td>
<td><strong>Normal Distributor</strong></td>
</tr>
<tr>
<td>Marketing</td>
<td>Yes (Extensive)</td>
<td>Yes (within industry standards)</td>
</tr>
<tr>
<td>After Sales Services</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Inventory Management</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Furniture / Fixtures / Communication facilities</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Warehousing facilities</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Marketing Intangibles</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Customer List</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td><strong>Risk</strong></td>
<td><strong>Normal</strong></td>
</tr>
<tr>
<td>Market Risk</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Price Risk</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Inventory Risk</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Product Liability Risk</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Credit Risk</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Warranty Risk</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
## Typical FAR of Service Providers

<table>
<thead>
<tr>
<th>FAR</th>
<th>Functions and Assets</th>
<th>Types of Service Providers</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Entrepreneur / Normal risk service provider</td>
<td>Low risk service providers</td>
</tr>
<tr>
<td>R &amp; D</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Significant People functions</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Quality</td>
<td>Yes – assume overall responsibility</td>
<td>Limited to the extent of services performed</td>
</tr>
<tr>
<td>Marketing</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

### Risk

<table>
<thead>
<tr>
<th>Risk</th>
<th>Normal</th>
<th>Less than normal</th>
<th>Limited</th>
</tr>
</thead>
<tbody>
<tr>
<td>Man Power recruitment / attrition</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Service liability</td>
<td>Yes</td>
<td>To the extent of service performed</td>
<td>No</td>
</tr>
<tr>
<td>Capacity utilization risk</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Regulatory</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Foreign Exchange</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Credit Risk</td>
<td>Yes</td>
<td>No</td>
<td>No – Advances</td>
</tr>
</tbody>
</table>
Case Study 1

Facts
• ABC USA develops, manufactures and markets cancer related products
• ABC India is engaged in the business of import and resale of these products in India

Entities Involved

Outside India

Import of Products

ABC USA

India

Distribution

ABC India

Functions Performed
- Manufacture
- Research & Development
- Quality Control
- Sales & Distribution
- Distribution
- Warehousing / Inventory

Customers
### Types of Assets

<table>
<thead>
<tr>
<th>Types of Assets</th>
<th>ABC India</th>
<th>ABC USA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employees</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Property, Plant &amp; Equipment</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Intangibles such as trade licenses, know-how, etc.</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

### Types of Risk

<table>
<thead>
<tr>
<th>Types of Risk</th>
<th>ABC India</th>
<th>ABC USA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product Development Risk</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Market Risk</td>
<td>Yes (limited)</td>
<td>Yes</td>
</tr>
<tr>
<td>Manpower Risk</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Credit &amp; Collection Risk</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>General Business Risk</td>
<td>Yes (limited)</td>
<td>Yes</td>
</tr>
<tr>
<td>Foreign Exchange Risk</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>
Case Study 1

Economic Characterization – Based on the FAR analysis

- ABC USA should be characterized as the 'Entrepreneur'; and
- ABC India as 'Limited Risk distributor'
XYZ India and XYZ USA perform the following functions:

<table>
<thead>
<tr>
<th>XYZ India</th>
<th>XYZ USA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Procurement &amp; Warehousing</td>
<td>R &amp; D</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>Manufacturing</td>
</tr>
<tr>
<td>Design and Engineering</td>
<td>Marketing &amp; Promotion</td>
</tr>
<tr>
<td>Quality Assurance</td>
<td>Procurement &amp; Sales</td>
</tr>
<tr>
<td>Export of Finished Goods</td>
<td>Invoicing &amp; Collection</td>
</tr>
</tbody>
</table>
Scenario 1: When XYZ India sells components to AE as well as third parties

- Third party supplier
- Sale of finished goods
- Purchase of components
- Outside India
- India
- Third party supplier
- XYZ USA
- Sale of finished goods
- Purchase of components
- XYZ India
- Third parties
Case Study 2

Economic Characterization

- XYZ India: Normal Risk Manufacturer
- XYZ USA: Normal Risk Manufacturer
Scenario 2: When XYZ India sells components to only to its AE

- Third party supplier
- Purchase of components
- XYZ USA
  - Sale of finished goods
- Outside India

- Third party supplier
- Purchase of components
- XYZ India
- India
Case Study 2

Economic Characterization

- XYZ India: Right to right to sell to AE only - Characterized as a contract manufacturer
- XYZ USA: Entrepreneur
Economic Analysis
Economic analysis – Process Flow

- Functional Analysis
  - Functions
  - Risks
  - Assets

- Entity Characterization

- Tested Party

- Economic Analysis
  - Selection of Most Appropriate Method
    - Benchmarking

- Financial Analysis
  - Profit Level Indicator

- Arms Length Price Determination
Key Takeaways
Key Takeaways

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

• Comparability strictly based on FAR- intangibles, risks play important role

• Adjustments to comparables necessary to account for differences in FAR
Thank You

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