

DIGITALES ARCHIV

Abdallah, Wagdy M.

Article

The conversion from US-GAAP to IFRS and transfer pricing

Provided in Cooperation with:
Danubius University of Galati

Reference: Abdallah, Wagdy M. The conversion from US-GAAP to IFRS and transfer pricing.

This Version is available at:
<http://hdl.handle.net/11159/406>

Kontakt/Contact

ZBW – Leibniz-Informationszentrum Wirtschaft/Leibniz Information Centre for Economics
Düsternbrooker Weg 120
24105 Kiel (Germany)
E-Mail: [rights\[at\]zbw.eu](mailto:rights[at]zbw.eu)
<https://www.zbw.eu/econis-archiv/>

Standard-Nutzungsbedingungen:

Dieses Dokument darf zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden. Sie dürfen dieses Dokument nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, aufführen, vertreiben oder anderweitig nutzen. Sofern für das Dokument eine Open-Content-Lizenz verwendet wurde, so gelten abweichend von diesen Nutzungsbedingungen die in der Lizenz gewährten Nutzungsrechte.

<https://zbw.eu/econis-archiv/termsfuse>

Terms of use:

This document may be saved and copied for your personal and scholarly purposes. You are not to copy it for public or commercial purposes, to exhibit the document in public, to perform, distribute or otherwise use the document in public. If the document is made available under a Creative Commons Licence you may exercise further usage rights as specified in the licence.

The Conversion from US-GAAP to IFRS and Transfer Pricing: Irreconcilable Differences

Wagdy M. ABDALLAH¹

Abstract: Purpose- This paper aims to discuss the challenges of the switch from the US GAAP into International financial Reporting Standards (IFRS) pose multinational companies (MNCs); to investigate the transfer pricing of intangible assets with several important trends in the global market; to analyze and discuss the impact of the conversion on intangible assets' transfer pricing decisions; and to make recommendations to help alleviate problems associated with transfer pricing when switching to IFRS.

Design/methodology/approach-The author addresses the conflicts between using the International Financial Reporting Standards and the transfer pricing policies as the multinational companies make the switch from using the GAAPs to the IFRS and propose some remedies to the related problems.

Findings- Transfer pricing systems of MNCs should be carefully reviewed and updated because financial statement information is used and comparability of that information between tested parties and companies to which they are compared is critical to achieving a reliable analysis to help MNCs achieving their global strategic objectives.

Research limitations/implications-This research focused on the significant implications on the American MNCs' transfer pricing strategic decisions resulting from the adoption of the IFRS in general. Further research is still needed to examine the impact of the conversion process on both foreign subsidiaries and the MNC as a whole in different industries.

Originality/value-The paper addresses an issue of significant implications on transfer pricing strategic decisions of intangible assets beyond financial reporting as a result of converting financial statements from U.S. GAAP to IFRS.

Keywords: Comparability, E-commerce, Global accounting standards, Profit-based methods, Income tax consequences.

1. Introduction

Success in establishing International Financial Reporting Standards (IFRS) as one set of global accounting standards in more than 100 countries, including the U.S., by the International Accounting Standards Board (IASB) depends to a large extent on how soon the U.S. Securities and Exchange Commission (SEC) will require the American companies to switch from the GAAP to IFRS. There exists the possibility it may never do so. Nonetheless, confidence and trust in comparable financial statements of MNCs are needed for both investors and creditors of the global financial markets regardless of their locations as well as which set of standards they use.

With respect to transfer pricing strategies, for the past three decades, MNCs have experienced no business function that goes so deeply into nearly all international operations, including manufacturing, marketing, management, and financing, as

¹Professor, Seton Hall University, U.S.A., Department of Accounting and taxation, wagdy.abdallah@shu.edu.

international transfer pricing (Abdallah, 2004.) Transfer pricing strategic decisions have great impact on foreign operations of MNCs, directly affecting their global revenues and profits, and can help limit an MNC's ability to operate, manage, and utilize its economic resources on a global basis for the purpose of achieving its ultimate strategic goals. Responding to increasing globalization, overwhelming use of e-commerce and growing international trade in services and intangible assets make it a much more complicated issue with the use of the IFRS. The application of Section 482 has tended to focus on the concept of comparing intragroup transfer prices with arm's length third party prices.

Recently, American MNCs have changed their ways of conducting international business from the traditional way on a country-by-country basis to the adoption of global business models, such as e-commerce and shared services or intangible assets. Within MNCs, an international transfer pricing is a source of conflict of objectives. However, for all MNCs, one common objective of strategic tax planning for intangible assets is to reduce their worldwide long-term tax liabilities.

When moving intangible assets across the borders to reduce taxes, MNCs frequently assign income to special purpose subsidiaries in tax-heaven countries. However, most tax regulations require that profit follows the underlying economic value drivers. Tax-induced special purpose subsidiaries are either risky or complicated to implement. In a number of cases, moving conventional intangibles across the border does require prohibited high buy-in (transfer pricing) payments. Knowledge intangibles, on the other hand, derive their value from the pooling of fragmented preeminent intangibles that have little standalone value and thus require minimal transfer pricing payments. Therefore, financial executive officers (FEOs) of MNCs should identify and pool fragmented knowledge assets tax efficiently (Collardin and Alexander, 2002).

However, many MNCs' transfer pricing systems do not sufficiently respond to the applicable several tax regulations, and they impose indefensible tax compliance risks on MNCs. Internally based profit allocation formulas often conflict directly with the arm's-length principle. In practice, even when MNCs use market-based methods for transfer pricing, the comparable prices are often based on simple industry averages or are not sufficiently analyzed to adjust for functional or economic differences.

For the IRS-U.S., the common features of a transfer pricing regulation include adoption of the arm's-length pricing principle, requirement of extensive documentation in support of the transfer pricing methods to determine prices, and imposition of stringent penalties for noncompliance. Moreover, with the globalization of MNCs and rapid expansion in the cross-border flow of digitized goods, services, and technology, national tax authorities have been addressing transfer-pricing issues with increasing scrutiny, documentation and penalties.

Under Section 482 of IRC, the permissible methods for determining an arm's-length price are: (a) comparable uncontrolled price method, (b) resale price method, and (c) cost plus method. The three methods are required to be used in order, and a fourth alternative method may be used for all other situations in which none of the first three are considered appropriate and reasonable. The fourth one

can be based on profit-split approaches such as the comparable profits method and several split-profit methods.

As part of the convergence from the U.S. GAAP into the IFRS by the Financial Accounting Standards Board (FASB), it includes the change from the rules-based standards, as implemented by FASB and SEC, with specific application guidance to the principles-based standards, as implemented in the development of the IFRS by IASB, with limited application guidance. A principles-based approach to accounting standard setting refers to the development of accounting standards that provide the basic guidelines for accounting in a particular area without getting down into specific detailed rules. Moreover, the differences between the two sets of accounting standards might create significant impact on the use of transfer pricing strategies for American MNCs.

Now, when American MNCs make a conversion from the U.S. GAAP to the IFRS, there is direct impact on both of (a) financial reporting; (b) how to comply with Section 482 of Internal Revenue Code; (c) how to use transfer pricing strategies and (d) other income tax consequences of the IFRS effective changes to the items to be included on the financial statements. The significance of the impact of the conversion depends on the circumstances of each MNC, its functions, and its risk.

The following sections of this research paper discuss four important topics. First section describes the challenges involved in the convergence from the US GAAP to IFRS poses and in addition it will survey the advantages and disadvantages of the conversion from the US GAAP to IFRS. Secondly, transfer pricing of intangible assets with several important trends in the global market will be investigated. In the third section, the impact of the conversion on intangible assets' transfer pricing decision will be analyzed and discussed for both traditional transaction-oriented transfer pricing and the profit-based methods. In section four, several recommendations will be offered to help American MNCs to alleviate the problems associated with transfer pricing when converting from the US GAAP to IFRS.

2. Challenges with the conversion from the US GAAP to IFRS

In February 2010 the U.S. Securities and Exchange Commission (SEC) released a Statement on Global Accounting Standards that has paved the way for a 2011 decision. As can be implied from this statement the earliest that U.S. issuers would be required to report under IFRS would be 2015, with these companies being required to provide comparative financial statements for periods beginning as soon as 2013. It is very important for the SEC to decide on the exact date for the ultimate move to IFRS. The rest of the world has already decided that the set of single set of standards should be the IFRS and definitely it will not be U.S. GAAP (Cunningham, 2010).

American MNCs will definitely be affected by IFRS at varying times and degrees of magnitude, driven by several factors such as industry, geography, size, and global strategic objectives. Until now, it is not clear when the SEC will make the adoption of the IFRS official for American business; however, the impact of

accounting changes will be significant and will have broad consequences on business decisions.

It appears that all countries, including the U.S., are on a clear path to move to use one set of global accounting standards. In fact, the one common theme we've seen in comments about the U.S. SEC's proposal to adopt IFRS is that everyone believes we should have one set of standards. The original proposal was issued under the previous administration (Cunningham, 2010). There are several advantages to making the conversion including: (a) the conversion is in the public interest and consistent with the SEC's investor protection mandate; (b) the potential of IFRS to become the only set of accounting and financial reporting standards that best provide a common platform on which companies can report and investors can compare financial information of different MNCs. However, the transition from the US GAAP to IFRS brings several challenges and could have significant impact on many MNCs' tax liabilities (Dhawale and Crosswy, 2009).

Unfortunately, the switch to IFRS from the local GAAP may be an issue for MNCs with a substantial presence in the U.S. market. When MNCs use IFRS as the group accounting standard, local books may still need to be kept based on the local GAAP for statutory purposes, before IFRS became required for local statutory reporting. This could become an issue resulting if the MNCs tries to test its global transfer pricing results (Riisberg et al, 2012.).

3. Transfer of Intangible Assets

Understanding the nature and the characteristics of intangible assets of MNCs and the related issues of transfer pricing systems is considered an essential step in designing the right and most appropriate pricing systems for MNCs. Intangible assets need different analysis than what are required with tangible assets, because they are the key to commercial success, especially in the hi-tech industry. Moreover, it may be difficult to use the traditional comparative analysis that is used with tangible assets since a MNC will be unwilling to risk involved in allowing unrelated parties to exploit their intellectual property. Therefore, it would be a big mistake for CEOs and financial executives of MNCs to believe that one system fits all.

Recently, MNCs and tax authorities have been facing greater challenges in dealing with transfer pricing of intangible assets. For MNCs, the challenges include: (a) the globalization of MNCs and rapid expansion in the cross-border e-commerce business transactions of services and technology; (b) the shift from a predominately manufacturing economy to a service economy stimulated by innovative technology; and (c) the increasing significance of intangibles in the production of income for MNCs.

Several important trends have increased the importance of transfer pricing of intangible assets for MNCs. First, the growing globalization of markets and a consolidation of market structure, such as the restructuring of the telecommunications, electronics, pharmaceutical, aerospace, and other industries in Europe, are the outcome of the elimination of trade barriers through a unified

European Union marketplace (Miesel et al, 2002). Second, in 1986, Section 482 of the US-IRC was amended to promulgate the “super royalty” provisions through the statutory commensurate-with-income standard. It was a response to the allegation of IRS that MNCs are not paying their fair share of tax to the U.S. tax authority and the tax court decisions where MNCs were alleged to be directing income to related groups in tax heaven countries (Levy, 2001). Then, U.S. and foreign tax regulations started to define this standard in terms of an arm’s length result; the OECD members used the same rules in their respective tax regulations. As a result, the documentation rules became the global tradition, and transfer pricing tax audits of MNCs dominated tax disputes among most foreign tax authorities (Ibid.). Finally, the DHL court case has become a landmark and a good alert for MNCs’ transfer pricing adjustments of intangible assets.

Third, of increasing concern is the increasing alertness and sophistication of national tax authorities concerned with protecting their country's share of the taxable income earned by multinationals. Recently, every MNC has become aware of its responsibility and obligation to establish and document a sound and practical transfer pricing system. These documents became the focal point in all transfer pricing tax audits, and the MNC’s success in audit and its ability to maintain reasonable reserves for financial reporting purposes is directly proportional to the quality of the analyses. These benchmarks are also the key to success in any strategic tax planning program used by a MNC. Further, more tax authorities around the world are opening their doors to motivate MNCs to consider advance pricing agreements (Levey, 2001).

Finally, in the 21st century, the significant and fast development of e-commerce era and service companies’ paradigms in proportion to the bricks-and mortar business activities pushes the tax authorities to continue to look closely at the transfer pricing practice of MNCs. Many countries continue to issue new transfer pricing tax regulations and adjust old ones to meet the new e-commerce challenges. The e-commerce technology has encouraged MNCs to integrate their businesses with their suppliers and customers, regardless of the geographic locations concerned with the activity. E-commerce also facilitates the increasing globalization of business operations so that companies that have until now been confined to their national markets are now in a position to trade across borders. In the past, it used to take years or even decades to build up either name brand or market value on the basis of organic growth. Now, businesses with the e-commerce activities have seen large increases in brand and other intellectual property values over a much shorter timescale (Walsh, 2001).

4. The impact of the conversion on Intangible Assets’ Transfer Pricing Strategic Decisions

Most, if not all, countries use the arm’s-length as the international transfer pricing standard for both tangible and intangible assets. All cross-border business transactions between an American subsidiary and its foreign parent should be evaluated based on the contractual terms made by the two related parties on condition that such terms are consistent with the two parties’ behavior and the

economic substance of the related business transaction. The key issue in deciding whether uncontrolled transactions are really comparable to the related party transaction being tested is the extent to which the functions performed, assets used and risks borne by the related parties are sufficiently similar so that the profits realized in the uncontrolled transactions are a reliable indicator of the transfer prices that would be realized if the related parties were dealing at true-arm's length (Warner, 2002).

Traditional techniques of valuating intangible assets for tax purposes, such as comparable uncontrolled price or resale price methods, might apply in situations where comparable transactions are available or stable knowledge-induced cash flows can be identified. Normally, however, tax planners will not have access to such data and traditional valuation methods fall short (Collardin and Alexander, 2002). Even if the standalone value of a subsidiary's intangible property can be ascertained, such value is likely to be minimal compared to the value of the global intangible because knowledge or technology is usually arranged in networks. In practice, there are many difficulties in applying the arm's-length standard especially when a MNC conducts business transactions that independent companies would not undertake such as highly specialized intangible assets and/or e-commerce cross-border business transactions which allow MNC businesses to be highly integrated.

When one of the cost plus transfer pricing method, such as TNMM or PSM, is used, generally your company is compared to a set of comparable companies with similar function and risk factors. The most important part of this analysis is the actual degree of comparability of your company and the companies to which it is being compared. The comparability of the accounting principles used is one of the most important factors to be considered (Abell and Wisniewski 2009).

If your company uses U.S. GAAP, the comparable company must be using U.S. GAAP. By the same logic, if your company uses IFRS, the comparable companies also should be using IFRS. If your company considering the conversion from the U.S. GAAP to the IFRS, its transfer pricing methods and documentation should be investigated carefully because it may not be appropriate if they are comparing U.S. GAAP with IFRS.

In all likelihood, the current arm's-length international transfer pricing methods used by tax authorities for intangible assets, including services provided by a foreign company to an American subsidiary or an American MNC to its foreign subsidiary, would be evaluated under one of six transfer pricing methods: (a) the comparable uncontrolled price (CUP) method; (b) the resale price method (RPM); (c) cost plus method (CPM); (d) Comparable profit method (CPrM); (e) transactional net margin method (TNMM); or (f) profit split method (PSM). The first three are viewed as traditional transaction-oriented methods and the last three are profit-based methods.

4.1 Traditional Transaction-Oriented Transfer Pricing Methods.

MNCs using profit-based methods, such as comparable profits (CPM) or profit split methods in conjunction with external benchmarks to set or test their transfer

prices, could be affected to a greater degree by the transition to IFRS than companies that use transaction-based methods, such as comparable uncontrolled price (CUP), resale price, or cost plus, using internal benchmarks to set or test their transfer prices (Dhawale and Crosswy, 2009).

4.1.1 Comparable Uncontrolled Price Method (CUP). Under the CUP method the actual price of an intangible property charged by a MNC would be compared to prices charged for similar services performed or sold in comparable uncontrolled transactions including any sales by MNCs of the same goods or services to uncontrolled distributors in similar markets. In practice, unless the MNC sold the same product or performed the same service to uncontrolled customers in the U.S. or in a comparable market, it is not likely to use the CUP method. Even if a MNC sold its intangible property to unrelated party in the U.S. or in a comparable market, fees or prices charged in those cross-border business transactions would not be reliable indicators of arm's-length standard for sales to its American subsidiary unless such third party transactions were similar to sales to the American subsidiary in terms of (a) functions performed; (b) allocation of risks, and (c) contractual terms could be made to reconcile for the differences (Warner, 2002).

Each tax authority attempts to apply their own interpretation of the arm's length standard of intangible assets in order to ensure that MNCs report at least the same amount of income as independent and uncontrolled comparable companies operating in their respective countries. In making assessments and the corresponding income adjustments, often they do not consider the MNC's overall global profitability, economic factors, ownership of intangible assets, or other factors that may differentiate the situation of the taxpayer from the comparable local companies or comparable local transactions of intangible assets (Raby et al., 2002). Intangible asset prices determined by the CUP method may require adjustment for minor or major differences in intellectual property or circumstances of sale, but they are essentially alternative prices at which the intangible asset in the sale to a related party could have been bought on the open market (Miesel et al., 2003).

When US MNCs convert from the US GAAP to IFRS, the impact may be different from one company to another because of both of the exact circumstances, functions, and risks are not the same. In this case, if we look at the transfer pricing of tangible assets for companies using the CUP method, as a result of using the market prices as the appropriate price between related parties; the differences in net income because of the conversion into IFRS will have no effect on transfer pricing and there should not any modifications to be made in this case. However, if the transfer pricing is used for intangible assets, the impact will be more complicated due to the fact that the exact details of the contracts with both of the related parties and their comparable need to be known before any conclusion can be drawn. For example, management fees or royalty rates charged to foreign related subsidiaries of MNCs may be determined based on the financial statement information.

The range of the arm's-length standard may shift when the company uses the IFRS for their financial reporting requirements. For intangible assets, when a MNC uses

the CUP, there will not be any impact on their transfer pricing because the CUP method requires the use of the arm's-length market price in determining the appropriate transfer pricing between the affiliated entities. However, if another method such as the comparable uncontrolled transaction method is used to determine the appropriate transfer pricing, there will be an impact on transfer pricing depending on the details of their contracts with related parties and the contracts of their competitors.

4.1.2 Resale Price Method (RPM). Arm's-length price of an intangible asset is computed by looking at the gross margin earned by the American subsidiary from re-sales of intangible goods purchased from or services performed by a foreign company would be compared to the gross margins earned by uncontrolled distributors from transactions in which they carried on similar functions. The RPM focuses on one side of the transaction, either the manufacturer or the distributor, and to estimate the transfer price using a functional approach. Unfortunately, gross profit information for comparable uncontrolled distributors may neither be available nor reliable as a benchmark for an arm's length standard (Warner, 2002). Under the RPM, it is assumed that competition among independent wholesalers or distributors in the external market leads to similar margins being earned on sales by wholesalers or distributors that are offering similar services or performing similar functions. The RPM establishes the price a buyer should pay to allow it to earn a gross margin similar to that earned by companies performing similar functions. All excess profit on the transaction is assigned to the seller. As with the CUP method, major adjustments are made to account for differences in the economic circumstances of the transaction and in the conditions of sale (Miesel et al. 2003). In applying the RPM effectively, comparability of functions and design of intellectual property is essential. Comparability is required under this method when two criteria are met: (1) there are similarities of the functions performed, risks assumed, and level of intangible assets to those of the related party whose transfer prices are being determined, and (2) the intangible assets are generally similar to the related party's assets. Comparability adjustments are made for some or most of the differences in the mix and intensity of functions performed, for economic conditions of the transaction, and for the conditions of the sale.

Let us assume, the ABC Company uses the RPM and sets the transfer price on purchases from affiliates to enable it to earn a gross margin close to the midpoint of the range of average gross margins earned by the comparable companies over the previous three years. During those years, ABC Company and its comparable companies reported their financial earnings using U.S. GAAP; the gross margin at the midpoint of the range earned by its comparable companies over the same three-year period was 20 percent. Beginning year 2015, the ABC Company adopted IFRS as its financial reporting standard. In this case, in moving from U.S. GAAP to IFRS, the only impact on the ABC Company's income statement was that development costs under IFRS dropped from \$30M to \$25M because of differences in accounting for development costs. Net sales remained at \$100M and given the transfer pricing policy in place the gross profit was equal to \$20M. Net operating income for the Company would be increased from \$5M under U.S. GAAP to \$10M under IFRS.

In this case, the ABC Company's gross profit would be the same and it will continue to earn a 20% gross profit; therefore, the adoption of IFRS would have no effect on the Company's gross profit using the RPM as a transfer pricing technique. Under these circumstances, using the RPM would be a best-case scenario in that the transfer pricing policy should not require any changes as result of the conversion into the IFRS.

4.1.3 Cost Plus Method (CPM). The transfer price is computed by multiplying the cost of producing or designing the intellectual property by an appropriate gross profit percentage to cover the functions it carries out. The appropriate gross profit percentage can be determined from comparable uncontrolled sales of the seller, another party of the uncontrolled sale, or unrelated parties. The implicit assumption underlying the CPM is that the competition in a large number of manufacturing firms will lead to similar prices and profit margins.

The CPM also requires comparable when the functions performed, risks assumed, and level of intangibles are the same as or similar to those of the related party. Adjustments are made for differences in sales and purchase terms; freight terms; inventory turnover; and other factors. Similarly, the production costs of the controlled (or related-party) manufacturer or the uncontrolled comparables may also have to be restated to reflect cost levels that are consistent with different life cycles of the intangible assets. Markups on comparable products, for example, may be fairly different depending on the channeled service dealers, drop-shippers, or manufacturers' sales branches (Miesel et al., 2003).

As an illustration assume the Company sells its products to unrelated parties and similar, but not identical, products to its related-party affiliates. The Company charges its affiliates on a cost plus basis commensurate with the markups charged to third parties for similar products. That is, the transfer price charged to its affiliates based on the cost plus method is determined so as to enable the Company to earn the same gross profit on these sales as those earned on the sales to unrelated parties. The cost base to which the markup is applied is calculated in the costing system based on the accounting principles of the Company's financial reporting system.

A transition by the Company from U.S. GAAP to IFRS could require the Company to change its costing system to comply with IFRS; therefore, the cost base from which Company B determines its markup on costs could change. For example, assume that the Company sells VCRs for \$198 to third parties and the reported costs to produce a widget totals \$180 under U.S. GAAP. Thus, the Company earned a markup of 10 percent on VCR sales to unrelated parties and sets the price of VCRs sold to affiliates by marking up the costs to produce the VCRs as reported under U.S. GAAP by 10 percent.

When the Company switches from US GAAP to IFRS, the reported costs may change to produce the VCR. If the costs to produce a VCR under IFRS were \$165, while the sales price of the widget to third parties remains at \$198, this would increase the markup for a CPM to a cost plus markup of 20 percent instead of 10 percent. In this case, the Company would need to change its transfer pricing policy

regarding sales of similar products to affiliates to reflect the cost, plus 20 percent earned on sales of similar products to third parties.

4.2 Profit-Based Methods

4.2.1 Comparable Profits Method (CPrM). According to Section 482 of the IRC of the U.S., the CPrM is defined as a profit-based transfer pricing method that compares the operating profits of a controlled entity with the operating profits of a set of uncontrolled entities performing similar functions and incurring similar risks. To be consistent with the arm's-length standard, the operating profits of these uncontrolled companies define an arm's-length range of results, and the comparable profit method requires that this range be comprised of companies that demonstrate a similar level of comparability. In applying the comparable profit method, the analyst should provide evidence that those companies comprising the arm's-length range have a similar level of comparability in terms of their respective functional performed, risk assumed, and ownership of intangible assets (Johnson, 2001).

Under the comparable profits method, the American subsidiary's operating profits from its distribution activities would be compared with the operating profit of similarly uncontrolled distributors in terms of the rate of return on assets or capital employed sales, operating expenses, or other benchmarks. The key factors in determining whether an uncontrolled distributor's business activities are comparable to those of a controlled party for the purposes of applying the comparable profits method are the similarities in functional and resource or asset similarity.

This method compares profitability of the tested MNC to the profitability of the comparable companies using different earnings indicators. When a MNC's profitability changes because of the conversion from the US GAAP to IFRS, there would be a major change in the transfer pricing analysis which may be caused by either a change in the profitability results of the tested transaction, a change in the comparable companies' results, or both (Riisberg et al; 2012).

4.2.2 Transactional Net Margin Method (TNMM) There are some similarities and differences between the TNMM and the traditional transactional methods. First, the TNMM is similar to traditional transactional methods in that data on similar arm's-length companies is used at a micro level. Second; there is a key difference in that TNMM provides the appropriate mark-up on total costs (such as cost of goods sold, selling and general administrative expenses) as opposed to the appropriate mark-up on cost of sales. Third, TNMM is less direct and accurate relative to traditional transactional methods because operating costs include fixed overheads that may be assigned on an arbitrary basis. Fourth, TNMM is often used on a company-wide macro level rather than the micro level stipulated by the OECD. Moreover, the TNMM analysis is more popular because it is easily identifiable in terms of its simplicity, efficiency and cost. The TNMM requires much less information and is more tolerant of transactional and functional

differences than any of the more direct transactional methods. Furthermore, since the TNMM uses the net margin as its operating profit indicator, a positive result suggests that all the transactions undertaken by the tested subsidiary produce an aggregate result which is in accordance with the arm's-length standard.

The TNMM has become the transfer pricing method of choice because it requires less detailed information, does the work of what would otherwise take several analyses and, therefore, produces a finished transfer pricing report in a fraction of the time it would take to analyze each related party transaction independently. Although the aforementioned tendency is a distinct possibility, this reform still does not address the best method rule, thus leaving the possibility for a legal loophole. In this respect, it is important to point out a few facts (Narvaez-Hasfur and Torrey, 2002). However, the TNMM and the CPrM are very close to each other. Under the TNMM, U.S. or foreign tax authorities compare (1) the net profit margin on an appropriate base earned by comparable outside parties on comparable uncontrolled transactions with (2) the net profit on the same base earned by the related parties. The key issue is that TNMM is to be applied on a transactional rather than on a firm basis. The two methods are economically the same when applied appropriately (Miesel et al., 2003).

Under this method, the conversion into IFRS could create an issue when assessing whether an adjustment needs to be made as a result of the transition. In this case, the expected results projected under US GAAP at the time the transaction was initiated might not be comparable with the actual earnings computed under IFRS when testing whether the commensurate-with-income standard has been implemented (Abel and Wisniewski; 2009.) Moreover, it is very important to assess whether net margin comparisons can be reliably made without adjustments to the profit level indicators regardless if there are differences in the accounting standards used by tested party and the comparable companies.

4.2.3 Profit Split Method (PSM). Two important issues have led MNCs and many consulting and CPA professional practitioners to choose a profit split method. First, intangible assets are more difficult to quantify using traditional transactions method and much of the residual profit of integrated business entities may be derived from intangible assets, and most tax authorities may have difficulties in identifying the intangible assets as a separate factor (Li, 2002). And second, traditional transactions methods, in some cases, fail to provide an economically sound basis of intangible assets for arm's-length standard (Miesel et al., 2003). If the profit split method applied properly, it may be a significant alternative to the traditional transactional or profit-oriented methods, and it addresses the uniquely bilateral features of certain transactions while adhering to the arm's-length standard (Ibid.).

While transactional methods use data at a specific intangible asset level, by focusing on specific business lines and a narrow cost base; the profit split method uses data on overall profit margins across all intangible assets and services performed to check whether the profit allocated to each entity is in line with that

earned by similar arm's-length parties. In practice, both the profit-split method and TNMM are easier and less costly to implement than the three transactional methods. Moreover, it is typically used in complicated cases when other methods are not adequate to price the functions performed.

There are two steps involved in applying the profit split method. The first step requires determining what portion of overall profit (or loss) can be readily attributed to individual subsidiaries. In the second step, the balance, which is an indistinguishable profit, is split among the various participants by employing a methodology consistent with the arm's-length standard, either by a market-based or non-market-based method (Ibid.). In practice, MNCs must follow the US transfer pricing tax rules to determine the amount of the buy-in to be paid by the foreign company to the American subsidiary. The foreign company could utilize the profit split method for valuation of the transferred intangible assets. Often, the residual profit split method is used to value the buy-in. That method splits the intangible profit between legacy technology and new technology to be developed under the cost sharing agreement (CSA). The split is based on the relative R&D costs incurred before and after the CSA. The buy-in amount is usually structured as a declining royalty over the life of the legacy technology (Ossi et al, 2001).

For a reliable application of a profit-split method for evaluating the arm's-length concept of intangible assets transferred, it is important to understand the financial reporting system used by the controlled affiliate and the comparable companies. Moreover, if transfer pricing analysis is performed, net operating income and specific balance sheet items are the key issues for both of profit level indicators and the reliability adjustments. In the process of evaluating the operating net income, the differences in the classification between operating results and other income, or expense make the comparability issues more complicated (Abell and Wisniewski 2009). In addition, the commonly used profit level indicators in the transfer pricing analysis process such as return on investment, return on sales, and return on assets are significantly affected by the financial reporting standards used for both income statement and balance sheet items (Ibid.)

Under this method, a MNC's profitability definitely changes because of the conversion from the US GAAP to IFRS. As a result, there would be a major change in the transfer pricing analysis which may be caused by either a change in the net operating income results of the tested transaction, a change in the comparable companies' results, or both.

5. Discussion and recommendations

The process of converting into IFRS from U.S. GAAP can have a significant direct impact on transfer pricing methods, income taxes, financial reporting, and global transfer pricing strategies of American MNCs. In general, American MNCs may use two types of transfer pricing methods: transaction methods such as CUP, resale price, and cost plus; and profit-based methods such as comparable price method, transactional net margin, and profit split method. Transfer pricing policies and testing procedures that use profit-based methods compared to those using

transaction-based methods potentially would be most affected during the conversion from the US GAAP to IFRS. Moreover, American MNCs using external benchmarks for setting or testing their transfer pricing methods also could face greater problems in implementing their transfer pricing during the conversion from the US GAAP to IFRS than companies using internal benchmarks for setting or testing their transfer prices.

Transfer pricing systems of MNCs should be carefully reviewed and updated because financial statement information is used and comparability of that information between tested parties and companies to which they are compared is critical to achieving a reliable analysis to help MNCs achieving their global strategic objectives. Further research is still needed to examine the impact of the conversion process on both of foreign subsidiaries and a MNC as a whole in different industries.

6. References

- Abdallah, Wagdy M. (2004). *Critical Concerns in Transfer Pricing and Practice*, Praeger Publishers, West Port, Connecticut.
- Abell, Chester and Wisniewski, James J. (2009). "Transfer Pricing Considerations for Successful IFRS Conversion," *Tax Management Transfer Pricing Report*, Volume 17 No. 20, pp. 784-785.
- Collardin, Marcus and Alexander Vogele. (2002). "Knowledge intangibles--leveraging the tax advantages," *International Tax Review*, Volume 13 No. 7, (July/August), pp. 59-61.
- Cunningham, Coleen. (2010). "Will U.S. ever be converged completely?" AICPA; June 03) <http://www.aicpa.org/publications/newsletters/corpfininsider/2010/june3/pages/ifrsintheus.aspx>
- Dhawale, Hareesh and Crosswy, David. (2009). "Potential Transfer Pricing Considerations Arising from Replacement of U.S. GAAP by IFRS," *Tax Management Transfer Pricing Report* (Nov 5), pp. 673-686.
- Johnson, Robert E. (2001). "The role of cluster analysis in assessing comparability under the U.S. transfer pricing regulations". *Business Economics*, Volume 36 No. 2, (April), pp. 30-38.
- Levey, Marc M. (2001). "Transfer Pricing – What is next," *International Tax Review*, (Supplement: The Best of the Best), June, pp. 91-92.
- Li, Jinyang. (2002). "Global Profit Split: An Evolutionary Approach to International Income Allocation," *Canadian Tax Journal*, Volume 50 No. 3, pp. 825-869.
- Miesel, Victor H; Harlow H Higinbotham and Chun W Yi. (2003). "International transfer pricing: Practical solutions for intercompany pricing-Part II," *The International Tax Journal*, Volume 29 No. 1, (winter), pp. 1-40.
- Miesel, Victor H.; Harlow H. Higinbotham and Chun W. Yi. (2002). "International transfer pricing: Practical solutions for intercompany pricing," *The International Tax Journal*, Volume 28 No. 4, (fall), pp. 1-22.
- Ossi, Greg; Stuart Anolik and John Kilby. (2001). "Offshore operations." *International Tax Review* No. 4, (Supplement: E-Commerce), pp. 57-69.
- Raby; Nick; ; Kirsten Blum; Katherine Treasure and E Miller Williams. (2001). "US: Transfer pricing strategies." *International Tax Review*, (Supplement: Regional Guides: North America), pp. 19-25.
- Riisberg, Kristine, Deborah Keisner, and Todd Wolosoff. (2012). "Transfer Pricing Implications of the transition to IFRS;" *International Tax Review*; November.. Walsh, Mary. (2001). "Get the best value from intangibles," *International Tax Review*, Volume 12 No.2, pp. 23-36.

Warner, John P. (2002). "Taxing interbranch dealings: Application of separate taxpayer arm's length principles to inbound interbranch distribution dealings," *Tax Management International Journal*, Volume 31 No. 3, pp. 155-170.