Manual for Responsibility Centres

Transfer Pricing Associates

Technical information

Your bridge to worldwide transfer pricing services

Introduction

In accordance with the relevant transfer pricing guidelines, the selection of the most appropriate transfer pricing methods depends on the functional and risk pattern within a multinational group as well as ownership of tangible and intangible assets. TPA uses the classifications resulting from best practices in management accounting (i.e., responsibility centres, such as profit-, revenue-, investment- and cost centres) to determine the most appropriate method to price each transaction and to compensate each group company.

This Manual describes the common types of responsibility centres from a practical perspective and establishes the relationship with transfer pricing and the choice of OECD transfer pricing methods. It can be used as a mechanism to get from the findings of a functional analysis to choices of transfer pricing methods that are valid from economic and management control perspectives and thus more acceptable for tax purposes in an OECD context.

The use of the responsibility centres concept to structure an organization

In principle the Board of Management has the authority to make decisions within a multinational enterprise (MNE). Decisions by the highest management level within an enterprise about delegation of this authority or decentralization will be influenced by the following four factors:

- Maximum span of control
- The management style concerning the control and steering of the MNE
- Transaction costs
- The strategy and the business model applied by the MNE.

By delegation of its authority the top management will determine how a manager to whom authority is delegated will be compensated and/or how the manager will be steered and controlled.

Example: The Management Board of a French MNE gives the sales director of its German sales company the task to double turnover within a period of 3 years. In this case, one can opt to give the sales director a bonus on the basis of (a) solely the doubling of turnover or (b) a minimum required level of profitability of the sales company. The choice between a *revenue centre* (situation (a)) and a *profit centre* (situation (b)) depends on the four factors above. Also, in making this choice it is important to what degree the German sales company is considered to be able to manage and control the functions and risks related to situation (b). This information can generally be obtained on the basis of the traditional functional analysis techniques as described in the OECD Transfer Pricing Guidelines.

In summary, no cases are the same in practice in respect of the choices of roles and responsibilities. However, in order to structure the analysis of an existing situation, a number of tools are given below, describing the features of the most common types of responsibility centres.

The following descriptions address the following variables:

- The relationship between inputs and outputs of the responsibility centre determines the label. A responsibility centre can in practice consist of a department, a business unit, a legal entity, a geographical unit etc.
- A description of the type of activities which are common per responsibility centre
- A number of examples per responsibility centre
- The steering and control concept per responsibility centre
- The most common compensation method, both from a management and a tax perspective
- The legal framework.

Practical descriptions of responsibility centres

The following schedules are illustrations of the classification of certain activities as an expense centre, cost centre, revenue centre, profit centre or investment centre. In addition to the usual analysis of functions, risks and the use of assets per part of the MNE, the responsibility centre label adds a more process-oriented view on to the MNE, whereby one tries to identify (a) roles and responsibilities within a MNE and (b) value-added decisions.

Example: In the Italian parent company of a MNE all business decisions are made, whereas the parent company through the compensation method applied has been classified as a cost centre. The costs of the parent company are charged to the Belgian subsidiary, which formally acts a principal company – in other words, it gets the classification “profit centre”. However, taking into account that the staffing in Belgium is limited to factory workers, the responsibility centre labels – given the allocation of roles between Italy and Belgium – appear to be in conflict with the economic reality in terms of value-adding decision making.

Expense centres

- Relationship ‘input’/’output’
  - inputs are expressed in euros, outputs in units
  - output level and cost standards not or hard to determine
- Type of activities
  - strategically or operationally necessary
  - (almost) exclusively performed for group
  - mostly core
- Examples
  - highly creative, non repetitive tasks, e.g. core research

- corporate strategy department, e.g. strategic marketing

- Towards steering/control
  - determine expense/cost level (= budget)
  - monitor actual expenses/cost per department / account
  - focus on quality of processes, people and technology applied
- Common transfer pricing policy
  - actual cost are charged or allocated to recipient (budgeted costs +/- variances)
  - actual cost/benefit ratio is frequently reviewed
  - profit margin is meaningless from a managerial point of view
  - profit margin will be required for tax purposes
- Legal framework
  - mostly development contract or service level agreement

Cost centres (= engineered expense centres)

- Relationship ‘input’/’output’
  - inputs are expressed in euros, outputs in units
  - output level and cost standards can be determined
- Type of activities
  - operational activities, managed by principal entity
  - mostly performed for group
  - mostly non-core
- Examples
  - subcontracting of manufacturing activities
  - facility management activities
  - supporting activities of treasury department
  - IT system maintenance activities

- Towards steering/control
  - determine cost standards/targets per product etc.
  - monitor actual costs per product etc
  - analyse controllable and non-controllable variances
  - focus on cost/quality relationship
  - allows benchmarking of equivalent activities
- Common transfer pricing policy
  - standard cost times actual volumes are charged
  - sometimes non-controllable variances are settled
  - to apply a profit mark-up creates ‘pseudo profit centre’
  - profit margin could be applied from a managerial point of view
  - profit margin will be required for tax purposes, unless a third party would not be able to charge a mark-up
- Legal framework
  - mostly service level agreement

Revenue centres

- Relationship ‘input’/’output’
  - inputs and outputs are expressed in euros
  - output level and cost level not directly related
- Type of activities
  - market/customer driven activities
  - mostly performed for external customers
  - mostly core
- Examples
  - sales and distribution activities

- Towards steering/control
  - determine and monitor revenue levels
  - maximize quantities or prices
- Common transfer pricing policy
  - allocation of (contribution) margin of sales revenue
- Legal framework
  - mostly service level agreements (e.g. distribution company)

Profit centres

- Relationship ‘input’/’output’
  - inputs and outputs are expressed in euros
  - output level and cost standards can be determined
- Type of activities
  - market/customer driven activities
  - mostly performed for external customers
  - mostly core
- Examples
  - distribution activities
  - speculative activities of treasury department
- Towards steering/control
  - determine price levels and cost standards per product
  - monitor turnover, costs and profits per product
  - analyse variances
  - focus on profit contribution and quality
- Common transfer pricing policy
  - external/market price times actual volumes are charged

  - operating profit margin should - as primary way of measuring profitability - provide an adequate return on capital employed for

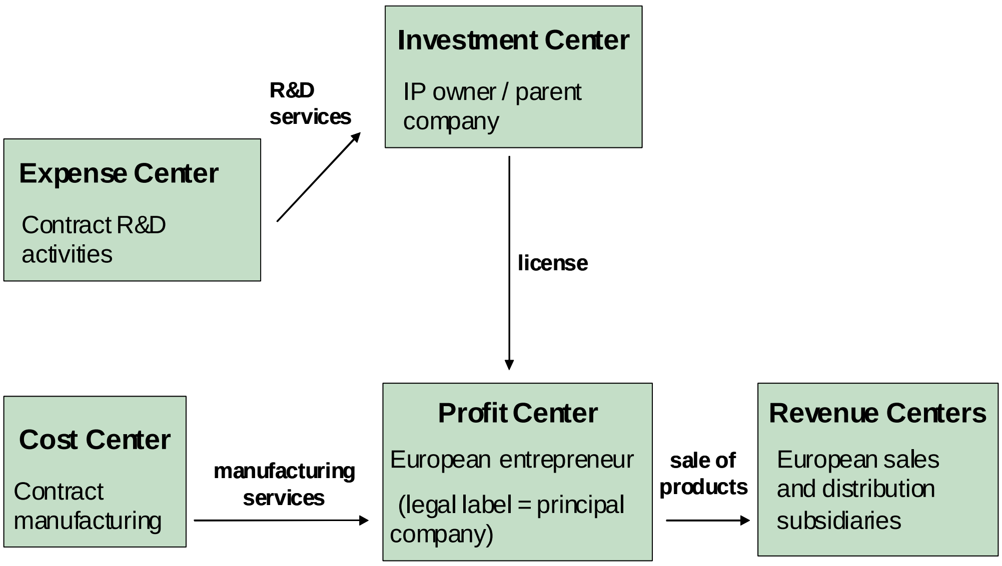
- Legal framework
  - mostly service level agreement with ‘cost centres’

Investment centres

- Relationship ‘input’/’output’
  - inputs and outputs are expressed in euros
  - relates profits to assets/underlying capital (=input)
- Type of activities
  - capital market/customer driven activities
  - mostly performed for shareholders/MNO as a whole
  - core
- Examples
  - intellectual property owners (return on investment on R&D)
- Towards steering/control
  - determine minimum required return on investment
  - monitor capital employed and profits per product
  - analyse variances on return on investments
  - focus on sustaining long term profitability of MNO
- Common transfer pricing policy[1]
  - EVA or RONA/ROCE measures should allow monitoring an adequate return on investment
  - remuneration based on residual income
- Legal framework
  - wide variety of legal agreements (if any)

[1] Note that an investment centre might not always be a party to inter-company transactions. An example is where an investment centre is placed in a holding company that only receives dividends as income.

Example of responsibility centres and inter-company transactions



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About Us

Transfer Pricing Associates (TPA) is the leading independent provider of global transfer pricing services and part of the TPA Global group. The TPA Global group is an independent and specialist provider of expert transfer pricing, tax valuation and customs services, headquartered in Amsterdam and with our own offices and coverage in over 25 countries around the world.

TPA provides high quality transfer pricing advice and assistance to multinationals of all sizes, wherever they are located. For more details of our innovative services, please visit our website at

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