

Does the Size of a Company Impact Profitability – Transfer Pricing Analysis for IT Sector



The heart of transfer pricing analysis lies in the comparability study undertaken by a taxpayer to establish the arm's length nature of the cross border transactions entered into by it with its group companies. Generally, the methodology adopted in the study comprises the use of both quantitative and qualitative criteria that may embed a certain degree of subjectivity, which is often challenged by Revenue Authorities. Since it is not feasible to qualitatively analyse every company for selection of the comparable companies, one has to compulsively apply quantitative filters. One of such filters is the turnover filter, which is the subject matter of this article. A question that arises is whether turnover filter is an appropriate filter for identifying comparable companies under transfer pricing regulations of India. There are conflicting decisions by tax tribunals. The same appears more to be based on common sense and emotions rather than on economic analysis. This article seeks to analyse this issue from legal as well as economic basis in the case of Information Technology sector. The economic analysis shows that size does matter during comparability study. Read on to know more...

The underlying logic of the turnover filter is the concept of "economies of scale". In simple language, it means that efficiency of production increases as the number of goods produced increases. A company that achieves economies of scale, lowers its average cost per unit through increased production, since its fixed costs are shared over an increased number of goods. Alternatively, this means that as a company grows and its production volume increases, the company will have a better chance to decrease its production costs. Adam Smith identified the division of labor and specialisation as the two key means to achieve a larger return on production. Through these two factors, employees would not only be able to concentrate on



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a specific task, but also, with time, improve the skills necessary to perform their jobs. The tasks could then be performed better and faster. There may be other reasons for achieving economies of scale as well. However, this increase has limitations. After a limit due to various factors like increase in costs, the trend changes, whereby a plateau is reached and there may be decrease in profitability.

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Comparability Criteria under Indian TP Regulations

Rule 10B (3) identifies the conditions under which uncontrolled transactions shall be comparable to the international transaction under question. ¹This provides that, if there are differences between two enterprises which can have material effect on the price or cost in relation to the transaction under examination then those two enterprises cannot be said to be good comparables. There is no guidance issued in respect of treatment of differences on account of size of the enterprises, hence one has to look at the international experience, decisions in India by various appellate authorities and the empirical evidences.

OECD and the Turnover Filter

There is no gainsaying that “comparability” is one of the most important factors in a transfer pricing study. The OECD defines ‘comparability analysis as “(A) comparison of a controlled and an uncontrolled transaction or transactions. Controlled and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor being examined in the methodology (e.g. price or margin), or if reasonably accurate adjustments can

be made to eliminate the material effects of any such differences².” Thus, in the analysis, once uncontrolled transaction (s) is identified one needs to identify differences between the controlled and uncontrolled transaction (s). The uncontrolled transaction(s) can be considered as “comparable” if ‘reasonably accurate adjustments can be made to eliminate the material effects of the differences. This is the underlying concept in identifying ‘filters’ for rejecting companies, while selecting comparable companies under the ‘deductive’ approach.³

The OECD in para 1.36 highlights the importance of attributes while deciding comparables. It says that “(I) In order to establish the degree of actual comparability and then to make appropriate adjustments to establish arm’s length conditions (or a range thereof), it is necessary to compare attributes of the transactions or enterprises that would affect conditions in arm’s length transactions.” Among the attributes, apart from functions, assets and risks, economic circumstances of the parties and the business strategies pursued by the parties are important.

The OECD identifies some of the most commonly observed quantitative criteria. These include⁴ size criteria of Sales, Assets or Number of Employees. It observes that “the size of the transaction in absolute value or in proportion to the activities of the parties might affect the relative competitive positions of the buyer and seller and therefore comparability”.

In view of the above, it can be inferred that the OECD is of the view that if companies have similar functions, assets and risk profile then the turnover would have an impact on profit margin. Consequently, companies having very different turnover should not be selected as comparables.

Recent Decisions on the Turnover Filter:

Discussed hereunder are some of the decisions by the Income Tax Appellate Tribunal (“the Tax Tribunal” or “Tribunal”). In most of the cases, the Tribunal has upheld application of turnover as a filter for identifying comparable companies.

¹ Rule 10B (3):an uncontrolled transaction shall be comparable to an international transaction if –

(i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market, or

(ii) reasonably accurate adjustments can be made to eliminate the material effect of such differences.

² Glossary, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2010 (hereinafter referred to as “OECD” or “OECD Transfer Pricing guidelines”)

³ Para 3.41, Page 119, OECD

⁴ Para 3.43 Page 120, OECD

*ST Microelectronics Private Limited*⁵

During the assessment years [“AY”] 2003-04, 2004-05 and 2006-07, the taxpayer rendered the aid software development services, along with provision of certain marketing support services, to its associated enterprises (“AEs”). For the purpose of benchmarking, the taxpayer aggregated these two types of services since the latter formed a very insignificant part of the entire revenue. Further, TNMM was selected as the most appropriate method with OP/OC as the profit level indicator.

The tax officer rejected the transfer pricing analysis of the taxpayer and identified a new set of comparable companies using various filters *inter alia* rejecting companies with total sales below ₹10 crore and above ₹1,000 crore and employee cost/total cost below 10%. Since the current-year data of these comparable companies exceeded taxpayer’s PLI by more than 5%, therefore the tax officer made an upward adjustment to the total income of the taxpayer.

The tribunal approved of the search methodology adopted by the tax officer and remarked that the taxpayer had failed to consider two key drivers of IT industry, viz. highly-skilled manpower and turnover in its search process.

Thus, the tribunal did not consider size of a company to be a significant factor in determining comparables.

*M/s DHL Express (India) Private Limited*⁶

Taxpayer, a wholly owned subsidiary of DHL World Wide B.V. Netherlands (Associated Enterprise or AE), is engaged in the business of courier services. During the year, the taxpayer had certain international transactions with its AE with respect to payment of network fees, reimbursement of expenses etc. For determination of arm’s length price of the above

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transactions, the taxpayer had adopted two comparable companies having average arithmetic mean of 3.91% against the taxpayer’s margin of 7.70%.

During the transfer pricing assessment proceedings, the taxpayer updated the comparable search and submitted a list of six comparable companies. Of these 6 companies, the tax officer rejected four companies on various grounds *inter alia* by adoption of a turnover filter.

The Tribunal ruled that the comparable companies with turnover less than 20% of the taxpayer’s turnover cannot be accepted, since the economies of scale are not available to small businesses operating in the same industry.

The Tribunal observed: “It is a universal fact that there are lot of differences between the large businesses and small businesses operating in the same field. In the case of small business economies of scale are not available and, therefore, generally less profitable.

However, the generic decision of the Tribunal to disregard the companies with low turnover *vis-à-vis* the taxpayer continues to be subjective, as the Tribunal did not comment on the appropriate threshold.

*Symantec Software Solutions Private Limited*⁷

In this case, the taxpayer challenged the huge adjustment on account of transfer pricing. Among various grounds taken before the tax tribunal, the taxpayer agitated against the rejection of application of turnover filter for identifying comparable companies. The taxpayers’ view was that the Transfer Pricing Officer (“TPO”) erred by accepting comparable companies of all sizes irrespective of their scale of operations.

The Taxpayer objected that the tax officer did not make any adjustments on account of differences in functional and risk profile of the comparables, with reference to the use of turnover filter to exclude companies. The Tribunal ruled in favor of the department stating that the taxpayer has not brought on record as to how such differences have influenced the result of comparability with empirical data, to the satisfaction of tax authorities.

While discussing the issue of turnover filter, the Tribunal highlighted the contention of the taxpayer that the comparables having more than ₹500 million and less than ₹50 million of turnovers should be excluded

⁵ *ST Microelectronics Private Limited* [2011-TII-63-ITAT-DEL-TP]

⁶ *DHL Express (India) (P) Ltd. Vs. Assistant Commissioner of Income-tax, 10(1), Mumbai* [2011] 46 SOT 379 (MUM.)/[2011] 11 taxmann.com 40 (MUM.) [27-04-2011]

⁷ *Symantec Software Solutions (P) Ltd. Vs. Assistant Commissioner of Income Tax-10(1)* [2011] 46 SOT 48 (MUM.)/[2011] 11 taxmann.com 264 (MUM.) [31-05-2011]

for determining the ALP, because the taxpayer's revenue from marketing support services was about ₹200 million. One of the arguments before the Tribunal was "that as per Rule 10B (3), if there are material differences between the transaction being compared, then, reasonably accurate adjustments should be made to eliminate the material difference." The taxpayer thereafter argued that "since the TPO has not made any such adjustment; therefore, the comparables, which are having more than ₹500 million and less than ₹50 million of turnovers should be discarded".

The observations by the Tribunal are very interesting and important. They observed as follows:

"There is no quarrel on the point that if the comparables proposed to be taken into consideration by the TPO are having an abnormal differences of turnover in comparison to the turnover of the assessee, and if it is apparent due to such abnormal difference in the turnover, the operating profits of the comparables got distorted then in such a case, those comparables should be excluded from the list of the ALP.

In the case in hand, the assessee raised these objections only because some of the comparables are having high profit and also high difference in turnover and not because of the high or low turnover has influenced the operating margin of the comparables. All the objections and contentions raised by the assessee in respect of this issue are general in nature and no specific fact has been brought on record to show that due to the difference in turnover the comparables become non-comparables. The assessee has not demonstrated as to how the difference in turnover has influenced the result of the comparables. It is accepted economic principles and commercial practice that in highly competitive market condition, one can survive and sustain only by keeping low margin but high turnover. Thus, high turnover and low margin are necessity of the highly competitive market to survive.

Similarly, low turnover does not necessarily mean high margin in competitive market condition. Therefore, unless and until it is brought on record that the turnover of such comparables has undue influence on the margin, it is not the general rule to exclude the same that too when the comparables are selected by the assessee itself."

Thus, in this case the Tribunal rejected the argument of the taxpayer to apply turnover filter on two counts – first, the taxpayer itself selected the comparables which it sought to eliminate by applying the turnover

The comparability analysis is the crux of the transfer pricing study conducted by any taxpayer. There is no mandate in the Indian Income-Tax Act or Rules that stipulates the exact way of conduction of this study. Naturally, the process applied by a taxpayer may vary from case to case. The subjectivity involved in the exercise has sparked umpteen numbers of debates on the issue of comparability and the application of quantitative filters to arrive at the closest set of comparable companies.

filter. Second, the taxpayer failed to show that turnover has undue influence on profits.

Frost & Sullivan (I)(P) Ltd.⁸

In this case, the Tribunal observes that the AO has considered companies with huge turnover as comparables. In fact, as mentioned by tribunal against the turnover of ₹10.82 crore of the company, the AO selected comparables which had turnover as high as ₹5,869 crore. The Tribunal finally held as follows:

"We, therefore, find merit in the submission of the Ld. Counsel for the assessee that there is no basis for only excluding loss making companies and not excluding the high profit making companies or companies which are not at all comparable considering their size, volume of turnover and other factors. In our opinion, the whole exercise of selecting comparables by the TPO is not proper and is in a haphazard manner." (Emphasis added)

The above references aptly highlight the relevance and importance of the turnover filter in the comparability analysis. Presently, the turnover filter has been conveniently adopted and shunned by the Revenue Authorities and taxpayers alike. Therefore, it becomes imperative for the taxpayer or the Revenue Authorities to substantiate the application of this filter in terms of a background analysis, rather than mechanically using it as an elimination tool.

Issues in the Use of the Turnover Filter

The debate that centers on the use of the turnover filter is twofold. *First, whether the use of this filter is justified (in reference to the service sector), by which one needs to analyse whether classifying companies of same scale of operations is at all required.* This would

⁸ [2012] 19 Taxmann.com 189 (Mumbai – Trib.); Order is dated 24 February 2012

compel one to examine the relationship between performances of the company, measured in terms of profitability and its size, measured in terms of turnover or sales. Alternatively, this means whether there is an impact of economies of scale on profitability. *Second, since it would not be feasible to find companies that have exactly the same scale of operations, what should be the range of companies that could be taken as comparable?*

Choice of Independent Variable

This article attempts to address the first issue, namely, finding the relationship between profitability of a company and its scale of operations. The second issue of the range of selection of comparable companies still remains subjective. This paper attempts to conduct a statistical analysis (in the service sector) to establish whether there is an impact of scale on the profitability of a company in the IT service industry. The industries covered in the analysis are in the following service sectors:

- BPO/ITeS
- Software Development services

A regression analysis is conducted with operating profit as the dependent variable and size or scale of operation of the company as the independent variable. The issue lies in finding a suitable financial parameter that can be adopted as a measure of scale of a company. The suitable options explored for selection of the independent variable are as under:

- Sales
- Employee cost
- Assets
- Number of employees
- Market capitalisation

Sales or employee cost seems to be the most appropriate measure of scale of operation of the company. However, for the purpose of the regression analysis, it is imperative that the dependent variable (here, operating profit) should not be related to the independent variable (say sales or employee cost, that being the most significant component of total cost for a service industry). As profit is calculated as Sales-Cost, neither of these variables could serve as the independent variable for the measure of scale.

Asset could be selected as a measure of scale of a company. It can be treated as an independent variable; it is not directly linked to the dependent variable, namely, operating profit. However, since the industries analysed are in the service segment, assets may not reliably reflect the scale of operation of a company. The primary value driver in the service sector is the human resource; hence, head count can serve as a better indicator of the size of a company in the IT sector. On the other hand, asset could be a good measure of the scale of operation for the companies in the manufacturing sector.

Having said that human resource is the primary value driver in service companies, number of employees is a good indicator of the scale or size of a company. However, the databases⁹ available to us do not have adequate information on the number of employees. Hence this variable could not be used.

For the purpose of this analysis, market capitalisation of a company has been used as the independent variable or the measure of scale of operation of a company. Market capitalisation is defined as the market value of the business of a company. It is often used as an indicator of the scale of operation of a company. It is calculated by multiplying a company's shares outstanding by the current market price of one share.

Statistical Analysis

The regression analysis will test a relationship between profitability and market capitalisation. The relation is hypothesised to be a simple non-linear form as under:
 $\{Profit = m (MC) + n (MC)^2 + C\}^{10}$ (1)

MC = Market Capitalisation

m = determines the impact on profitability for a change in the market capitalisation

n = determines the shape of the curve, a positive term indicates that as market capitalisation increases, the profitability keeps on increasing; and a negative term indicates that as market capitalisation increases, the profitability increases initially, then the increase slows down beyond a level.

C = intercept term

For the regression analysis, a sample of data has been collected from PROWESS database for the two industries:

- BPO/ITeS
- Software development

⁹ Refer Prowess database of CMIE for the purpose of this analysis to collect data

¹⁰ For the theoretical basis of the use of this non-linear form of regression model refer: William H. Greene: *Econometric Analysis, Fifth Edition*

Data has been collected based on certain financial criteria for the industries mentioned above. The companies selected qualified in the following financial criteria:

- Financial data on operating profit and market capitalisation exist for latest year
- Net sales greater than ₹1 crore
- Service income/Net sales greater than 25%
- Net worth positive

The detailed procedure of selection of the data is documented in Annexure 1. For selected sample of companies, data has been gathered for operating profit¹¹ and market capitalisation (annual market capitalisation). A sample of 97 companies was generated for the purpose of the analysis. The regression is run, to give the ordinary least square estimates of the coefficient and the intercept terms. The output results for IT industries are as under:



IT Sector:

SUMMARY OUTPUT						
Regression Statistics						
Multiple R	0.509123236					
R Square	0.25920647					
Adjusted R Square	0.243444905					
Standard Error	402.1083833					
Observations	97					
ANOVA						
	df	SS	MS	F	Significance F	
Regression	2	5318176.723	2659088	16.44548	7.51221E-07	
Residual	94	15198968.28	161691.2			
Total	96	20517145.01				
	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%
Intercept	-5.436406832	65.78935532	-0.08263	0.934319	-136.062714	125.1899004
X Variable 1	0.209130494	0.058244353	3.590571	0.000527	0.093484966	0.324776022
X Variable 2	-1.51505E-05	7.17454E-06	-2.1117	0.037365	-2.93957E-05	-9.05249E-07

Interpretation of Results

From the above, it can be seen that there is an impact of market capitalisation on profitability. The co-efficient term is positive and significant. This in layman’s language means that as the size or scale of operation (measured in terms of its market capitalisation) rises, the profitability of the company

also increases. Specifically, a one rupee increase in market capitalisation is associated with a twenty paise increase in profitability. The economic justification of the result emanates from the basis of the existence of scale economies. For example, as the size of a company increases, there is separate division that specialises in any particular work, depending on the skill of the labor

¹¹ Operating profit has been defined as Operating Income-Operating expenses

available. With the increase in specialisation, there is an increase in operational efficiencies that are achieved, this could be a possible reason for the increase in profitability of the company with increase in size.

The data has also been plotted in the graph below, the dots showing the actual data points of the sample. The trend line fitted further clarifies our analysis done above. As the market capitalisation increases the profitability increases, further the shape of the curve is one with a negative co-efficient term for the second order variable.



Thus, the above graph more clearly explains our analysis and the relation between market capitalisation and profitability. This relation can be logically explained as well, in the fact that due to increase in efficiency with the increase in size of a company the profitability rises. However, beyond a level of increase, it may not be as efficient to reap the benefits of economies of scale; this is due to the additional costs incurred on account of monitoring costs, etc.

Application to the Recent Cases

Now, the conclusion of the statistical analysis is applied to the recent cases mentioned above. Broadly, it can be said, the characteristics of the IT service companies would be driven by similar economic logic as is dictated by the norms of the industry in which it functions. It can be concluded from the analysis conducted in this article that there is an impact of scale in the IT industry. Hence, it can be safely concluded that in the case of all companies belonging to the same/similar industry there be scale effects in their profitability. When the search is conducted for comparable companies in the same industry their profitability would also contain the scale effect. This would mean, as the turnover increases for any firm belonging to this industry, their profitability would increase due to the benefits the firm can reap on

account of “economies of scale”. Hence the application of turnover filter to screen companies comparable to, say, ST Microelectronics is not an arbitrary process. This filter would automatically make an adjustment for the differences in profitability on account of scale effect from the universal set of companies to give the ones that would be better comparable to ST Microelectronics in terms of profitability. The very purpose of the transfer pricing analysis is to find companies that are the closest to that of the taxpayer in terms of functionality and hence reflected in its profitability.

However, it may be noted that the cases discussed are all in the IT service segment and hence, the importance of the application of the turnover filter in that industry.

Conclusion

The comparability analysis is the crux of the transfer pricing study conducted by any taxpayer. There is no mandate in the Indian Income-Tax Act or Rules that stipulates the exact way of conduction of this study. Naturally, the process applied by a taxpayer may vary from case to case. The subjectivity involved in the exercise has sparked umpteen numbers of debates on the issue of comparability and the application of quantitative filters to arrive at the closest set of comparable companies. It is understandable, that it is not feasible for the taxpayer to manually review the functional profile of all the thousands of companies available in the databases. Hence, it has to resort to some mechanism to screen the potential comparable companies before going for a closer qualitative analysis of them manually. The method adopted in all the cases of such comparable analysis is to apply financial screens, to arrive at a set more comparable to the taxpayer.

The revenue authorities understand the importance of this step in the entire process and themselves applied such screens in search strategy. The essence of the debate has now moved to the use of some quantitative research for justifying the application of these financial screens. The case of the turnover filter and the possible justification of its use have been discussed above. The conclusion that may be drawn from this limited exercise and the selected sample of data, tends to indicate the existence of a relation between size and profitability, hence the justification of the use of a turnover filter as a financial screen, when a large sample size is available. ■