

Transfer Pricing Documentation – Putting a Framework to the Test

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Abstract

Title: Transfer Pricing Documentation
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Problem description: During the last two decades the global trading has had a striking increase. The combination of increased internal transactions together with more complex structures of ownership within international companies have complicated the possibility of authority control of transfer pricing. In 1995 the OECD, Organisation for Economic Co-operation and Development, issued updated guidelines for use of transfer pricing in multinational companies. This resulted in a recommendation of the arm's length principle for transfer pricing. Companies in countries that regulate these guidelines by law can be expected to prove arm's length principle¹. This is done by documenting their transfer pricing by following several steps developed by the OECD. Sweden is expected to follow many other countries and regulate the guidelines by law sometime early in 2005. Many perspectives are already frequently debated and researched regarding this issue. However the company perspective in terms of compliance burden and the conflict between external demands and internal efficiency has not sufficiently been researched.

Purpose: The main objective of this study is to apply a framework of determining transfer pricing methods in a company, with the intent to describe and analyse its practical use. Further the authors hope to suggest improvements of the framework used, as well as present valuable lessons for a company faced with transfer pricing documentation requirements.

Methodology: Due to the practical nature of this study the empirical studies are estimated to have a higher degree of relevance of developing theory than the use of old theory. Therefore the inductive approach is argued to be dominant. The methodology is highly influenced by theory, as the framework applied outlines theories of which internal relationships are important to examine according to the OECD. The case specific relationships, which will be drawn from the empirical data, are in turn estimated to set limits and boundaries for the methodology. The data gathering is a large part of the study and was done in a qualitative manner and an interpretative approach.

¹ See chapter 1.1 for definition.

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Conclusions: The practical use of the framework must be considered in regards to the circumstances of the specific case. Examples and suggestions of framework improvements should therefore not be seen in absolute terms. Two major conclusions are found through the study. The first one addresses problems of using standardised models not adjusted to the specific case which leaves gaps in interpreting the documentation. Other stakeholders such as consultant firms may benefit from this and push the need for their services. The second conclusion outlines the need to put transfer pricing in operational and organisational context. In discussing these issues with the help of researched literature findings indicate how to view the extent of the transfer pricing documentation requirement issue. A cyclic relationship was found in terms of overall business planning, operational and legal business structure, extent of transfer pricing being used and the importance of the documentation requirement. These affect the need to focus on the documentation requirement. Depending on the degree of importance of the documentation requirement it may affect the overall business planning.

Key words: Transfer pricing, transfer pricing documentation framework, documentation requirements, OECD guidelines, tax authorities, external demands, compliance burden, organisational and operational demands

Dedications

Many people have contributed a great deal to this study. Throughout the working process we have received great support and help from a large number of people within the studied company. This reception did not only provide us with valuable information for the study, but also great personal experiences from working in a large multinational corporation. For this we would especially like to thank Ulrica Emanuelsson, Malin Johansson, Arne Hermansson and Jacob Malmros.

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1 Introduction

1.1 Background

There are various reasons for companies to engage in transfer pricing strategies. It can be seen as highly relevant for inter-profit centre relations as well as important in the design and implementation of management information and control systems. It is further essential in terms of strategic and operational decisions and known for having behavioural and performance appraisal consequences. Because of this transfer pricing has been the subject of extensive research over many years.² Once again transfer pricing is becoming a topic of interest and debate, this time in the light of increasing foreign trade. However it is not the companies themselves that want to raise the issue.

During the last two decades the global trading has had a striking increase and the multinational companies play a greater role today in world trade. The global trading has resulted in that many international companies have chosen to position units in countries. This has generated a higher global frequency of intern transactions such as products, services and funds.³ The combination of increased internal transactions together with more complex structures of ownership within international companies have complicated the possibility of authority control of transfer pricing. Difficulties of reviewing international companies and their businesses make it easier to transfer the collect of profit to countries with the lower tax proportion for profits.⁴

The OECD, Organisation for Economic Co-operation and Development, supports a positive development in the world economy by a free trade to generate the greatest economic development as possible in the member states. OECD has for some time been aware of the problem with reduced possibility for authority reviewing companies' activities. In 1995 updated guidelines for transfer pricing in multinational companies was issued. This resulted in a recommendation to use the Arm's Length Principle⁵ for transfer pricing. A controlled, or group company, transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realised if uncontrolled unit had engaged in comparable transactions under comparable circumstances. In other words the arm's length standard aims to no differences in profit margin of an intern sale and an extern sale, given that it is a similar product and the same recourses is provided.⁶

The development of the OECD documentation guidelines depends highly on the tax authority in the US, Internal Revenue Service. The US has always been ahead of the game when it comes to transfer pricing and sets the scene for what will probably happen in Europe a few years down the line. The US applies a more document

² Perera et al, (2003), p. 141

³ Skatteverket (2003) PM, p.8

⁴ Ibid

⁵ This principle is explained in chapter 1.2.2 below

⁶ Ibid

Transfer Pricing Documentation – Putting a Framework to the Test specific approach than the OECD.⁷ The development in the US has affected many other countries that trade and have entities in the USA.⁸ Since 1995 27 countries stated OECD's transfer pricing guidelines by law.⁹

During the last decade the number of Swedish companies with foreign ownership has increased. From year 2000 to 2001 the number of foreign owned companies in Sweden increased from 5100 to 7000. While the worldwide trading has increased the Swedish tax authority found it very important to simplify the prerequisite of transfer price control.¹⁰ There is a Swedish committee currently working on new regulations at the Swedish tax authority. Sweden is expected to follow many other countries and regulate the guidelines by law sometime early in 2005.¹¹

1.2 Problem Description

1.2.1 Putting Things in Perspective

To highlight some of the interesting dilemmas of this development we would like to point out a number of different aspects in regards to the background. This is done by describing perspectives of different stakeholders in the arena. By excluding some of these perspectives we finally find ourselves with addressing the essence of this study.

1.2.2 OECD Perspective

The OECD guidelines attempt to standardize the international transfer pricing and documentation requirements. The OECD provides a model that countries could use to develop local rules and regulations. This model sets guidelines for how to determine the arm's length principle in transfer pricing, which is the OECD's perception of an ideal state to deal with tax issues. The model, or framework, is outlined by seven steps which will result in the determination of a company's transfer pricing method, or methods, in use.¹²

To achieve an arm's length result in exchanges of tangible goods there are a number of three transaction-based methods that are accepted; comparable uncontrolled price, resale price and cost-plus, and two profit-based methods; comparable profit method and profit split, are endorsed by OECD and US, although the US is more in favour of profit methods than the OECD which see it as a last resort.¹³

The type of documentation required depends on the facts and circumstances of the individual case.¹⁴ There are however no differences made between different companies, industries, organisation forms or businesses. Regardless of these factors,

⁷ Stanley, (2001), p.25

⁸ Martinson & McKee (2001), p. 43

⁹ Ernst & Young Survey, (2003), p. 8

¹⁰ Skatteverket, (2003), p. 7-8

¹¹ Bergqvist, S., 2004-02-18

¹² Ossi et al., (2003), p. 289

¹³ Sayer, (1995), p.19

¹⁴ OECD Guidelines §5.16

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all companies are asked to produce the same content in the documentation.¹⁵ The actual way of how to consider case specific circumstances are therefore left in the dark.

In 2001 a conference held by the OECD in Holland among other things concluded a need for the OECD guidelines to remain flexible, with the ability to be interpreted by individual governments and to adapt to changes in business and the number of transactions taking place.¹⁶

1.2.3 Tax Authority Perspective

While businesses are operating globally, fiscal authorities are operating very much on a local basis among other things with setting aggressive transfer pricing rules. The UK is a good example of this, since 1998 penalties have been brought against corporations not applying the arm's-length principle when making returns of profits into the UK.¹⁷

As the beginning of 2004 there is a new group of full-time international tax specialists gathered to focus on transfer pricing issues within the Swedish tax authority.¹⁸ According to the Swedish tax authority, Swedish companies are committed to establish a documentation that contains the necessary information that motivates the price of the products and services. The price of the goods sold is supposed to be regulated in accordance with the OECD regulations. The purpose of the documentation from the authorities' is to simplify their possibility of review and control. The risks of illegal international transfer of profit and the risks of a company being duplicated taxed are through this actions decreasing.¹⁹

The experience of Bergqvist, a member of this committee, is that other countries have relied more and more on the Functional Analysis for this purpose. He says "this development is natural as the Functional Analysis reflects who should have the biggest piece of the pie".²⁰

Bergqvist further concludes that in large companies there are already report systems in use that should easily support the transfer pricing documentation. There are therefore not much of a compliance burden, at least for large corporations that closely monitor sales and have transfer-pricing as a common tool.²¹ The Swedish tax authority is one of the countries within OECD to regulate the guidelines by law fairly late.²²

¹⁵ Danish Documentation Planner, (1998), p2

¹⁶ Stanley, (2001), p. 25

¹⁷ Ibid

¹⁸ E&Y Survey, p. 67

¹⁹ Skatteverket, p.8

²⁰ Bergqvist, S., 2004-02-18

²¹ Ibid

²² E&Y Survey, p. 66

1.2.4 Perspective of Multinationals

Many countries within OECD have shown positive reactions to the guidelines and has issued laws stating that international companies who have business in the country have to be able to present documentation that motivate and explain their choice of transfer prices and that they are in accordance with the arm's length policy.²³ In turn, many multinationals welcome the move towards greater international consensus, as it offers the hope that profits will not suffer double taxation and that bitter disputes between tax authorities can be avoided. The worries they face are amongst other things the heavy burden of documentation.²⁴

There has not been any study on a worldwide scale of how multinationals comply with the international work of transfer pricing and documentation rules.²⁵ In the US a survey has shown that multinationals first consider the actual penalty exposure before deciding which transactions to document. Over half of the respondents did not document some of their transfer prices as they concluded they were correct and would not be subject for audit. 42 percent of the respondents indicated they lacked resources internally, such as personnel or sufficient budget to prepare documentation. Other reasons for not documenting was transactions were based on easily identifiable market prices, information in books was insufficient, cost of preparing documentation was too great, potential penalty audit adjustment would not reach penalty thresholds and cost of preparing documentation was greater than potential penalties.²⁶ The general conclusions are that multinational corporations, MNCs, try and avoid documentation if they can and see it as a compliance driven matter.

There is some information that can be drawn from the Ernst & Young survey of the reactions from Swedish companies regarding this development. First of all, as many as 81 percent believes that transfer pricing is the biggest international tax issue facing their group during the next two years. 81 percent believe that they are likely to be subject to a transfer pricing audit within the next two years.²⁷

1.2.5 Narrowing Down the Perspectives of the Study

To narrow down the perspectives of this study we wish to exclude some of the perspectives mentioned. There are many of these aspects that have been frequently debated and researched. The OECD perspective and the reasons for the documentation requirements are found to be well researched with a great presence of recent debate. The Swedish tax authority is however a new and interesting stakeholder in the arena. The observations of the authors have led to the conclusion that the Swedish tax authorities are in the process of gaining more knowledge of the documentation requirements and the continuing developments. They can mostly get this knowledge from the development present in other countries. It is the belief of the authors that the tax authorities are in need of stronger knowledge

²³ E&Y Survey, p. 8

²⁴ Sayer, (1995), p. 19

²⁵ Ossi, (2003), p. 294

²⁶ Ibid

²⁷ E&Y Survey, (2003), p. 66

Transfer Pricing Documentation – Putting a Framework to the Test and experience for beginning their work with reviewing companies sometime after 2005.

The perspective of multinationals is interesting as we can conclude that many are affected by the continuing developments. As Haigh argues; "If you're a multinational enterprise with many cross-border transactions, your transfer pricing is going to get audited"²⁸. This is similarly to the other perspectives well documented in surveys. However the issues of companies facing documentation requirements are merely described in general terms in the researched literature. How the steps in the documentation guidelines can actually be applied is therefore still left unanswered. Although some steps are identified as complicated; there is a lack of concrete and specific examples of such complicating factors. In light of this, the most interesting approach is argued to examine the practical use of a transfer pricing documentation by applying it and analysing the model in circumstances in one specific case.

By examining this, the authors believe that many other stakeholders can benefit other than the studied case company. Others in similar situations may benefit. The tax authority is indirectly a target and may be in need to be educated about the difficulties of documentation facing corporations. This includes the complexity of business that might affect the requirement. Some general conclusions should be applicable for other companies facing the same documentation requirement.

1.2.6 Demarcations

The issues of step six in the documentation, the comparability analysis, are debated the most, where examples of dilemmas can be found in researched literature. For this and other reasons mentioned in the methodology this section is not addressed further in this study. The vast area of transfer pricing research stresses the need to clarify that this study only concerns transfer pricing in terms of legal demands and not as a company management tool, although it is touched upon in the discussion.

1.2.7 Purpose

The main objective of this study is to apply a framework of determining transfer pricing methods in a company with the intent to describe and analyse its practical use. Further the authors hope to suggest improvements of the framework used, as well as present valuable lessons for a company faced with transfer pricing documentation requirements.

²⁸ Stanley, G. (2001), p.25

2 Methodological Considerations

The aim of this chapter is to put the study in context of theories of methodology and methodological factors of the specific study. The methodology used has shaped and determined the aim of the study, with strong implications for the outcome. In turn, the analysis and conclusions of this study should be put in context of the aspects presented here.

2.1.1 Methodology in Theory

Theory can be developed through deduction or induction. The deductive approach explains how new theories are developed from old ones. The Inductive approach sees the development of theory from empirical studies.²⁹ Due to the practical nature of this study the empirical studies are estimated to have a higher degree of relevance of developing theory than old theory. Therefore the inductive approach is argued to be dominant. However some deductive approaches may be seen in chapter five.

2.1.2 Theory, Relationship and Methodology

The methodology has to support the purpose of the study. A purpose can for example be to explain, describe or understand.³⁰ Most of the sub sections in the applied framework involve mapping out structures and relationships. The true nature of the study is therefore to describe one way the framework can be practically applied in order to understand reasons for the outcomes.

According to Wigblad there are three important dimensions to consider in establishing the problem definition. These aspects are relationship, theory and methodology, which together form a triangle as each and every one affects the other. There is almost in every case one dominant dimension that sets the circumstances for the other two.³¹

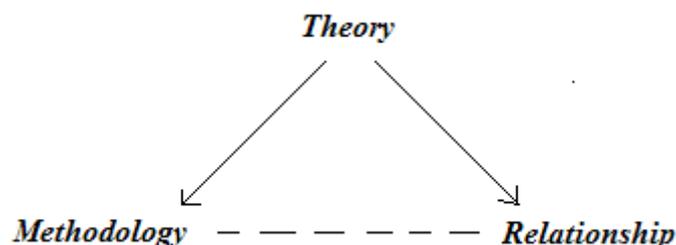


Figure 1: Elaborated Model from Wigblad, (1995) p. 20

In studying the practical use of applying a framework of transfer pricing documentation at Alfa Laval Lund the dominant dimension is argued to be the theory. The framework used is built on theories of arm's length, transfer pricing and several other theories that help frame the documentation requirement. The dimension of

²⁹ Alvesson et al., (1994)

³⁰ Wigblad, (1995), s. 27

³¹ Ibid, s. 20

Transfer Pricing Documentation – Putting a Framework to the Test relationship has several implications. It symbolizes how a specific framework is imposed by political, economic and legal demands, in other words external factors. There are also internal factors of consideration such as the relationships of structures, processes and responsibility. In essence, the relationship of the external and the internal factors in a specific case are examined through applying relevant theories. The methodology is therefore influenced by theory, as it provides suggestions and concepts of thinking. For example the theories in the framework applied outlines which internal relationships are important to examine according to the theories of OECD. The case specific relationships, which will be drawn from the empirical data, are in turn estimated to set limits and boundaries for the methodology. By putting theory in context of relationship we test the practical use of that theory. In this sense, the methodology used has to adjust to specific case.

2.1.3 Interpretive research – A part of Qualitative Analysis

Qualitative research methods are more interfering and less structured than quantitative research techniques and is therefore more appropriate when the research is exploratory in nature, when the area for examination is unfamiliar to the researcher and when the research is clinical. In all of these situations the interviewer must gain insight into a specific topic area.³² In this study, the authors were initially unfamiliar with the research, which has been the main reason for using this methodology.

Prasad and Prasad try and point out some overlaps and differences between qualitative research and interpretive research. The term qualitative research refers to methodological approaches that rely on non-quantitative modes of data collection and analysis. However, not as apparent is the fact that qualitative research can be conducted within positivistic as well as non-positivistic manners.³³

Qualitative positivism uses non-quantitative methods with assumptions about the nature of social and organisational reality and the production of knowledge. Reality is assumed to be concrete, separate from the researcher and possible to evaluate by so called objective forms of data collection.³⁴

Interpretive research refuses to play the rules of positivism, which has several implications in practice. This tradition sees social reality as a constructed world built through meaningful interpretations. The goal of the researcher is not to capture a pre-existing world, but to understand the symbolic world making. Interpretative research has also traditionally been closely identified with local meanings and everyday symbolic words. This addresses the micro worlds of individual interactions, organisational language and culture. They are separated from macro dimensions such as large-scale institutional processes, networks, and structures.³⁵

³² Jarratt, (1996), p. 6-15

³³ Prasad & Prasad (2002), p. 6- 7

³⁴ Ibid

³⁵ Ibid

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This study has had pieces of both qualitative and interpretive research. A model is implemented with the aim to produce a result according to pre-existing terms, structures and forms that are generally accepted in the macro environment. This is captured by the qualitative approach, which are somewhat in conflict with the micro factors of the case study. All those factors have been highly essential, and puts even more focus of the interesting dilemma of using one-model-for-all approach which is the message from the OECD and Swedish tax authority. This has many implications for working with transfer pricing documentation which are explored by applying the specific model used.

2.1.4 Data Gathering

The framework being used asked for a high degree of specific information. Data gathering was structured by consulting the framework, assessing the data needed and searching internally within the studied company as well as externally for cross-reference material. Although a lot of secondary data fulfilled the needs of the study, primary sources within the company were a great help in directing the authors to that source. For example the responsibility of various financial managers such as invoicing and cost allocation became a dominant parameter for finding key numbers.

According to Sampson (1972) in-depth interviews may be either non-directive or semi-structured. In non-directive interviews it is important that a relaxed, sympathetic relationship develops between the interviewer and the interviewee, and that leading questions does not cause bias in responses. It is also important that the interviewer must be able to guide the session back to the topic being explored when the interviewee digresses or exploration of a particular area becomes fruitless. On the other hand an open structure ensures that unexpected facts or attitudes can be easily explored.³⁶

25 persons were interviewed for the study at Alfa Laval Lund which make up representation from all activities and functions addressed concerned in the framework. Gathering primary data was time-consuming. Some attempts were made to perform surveys with a high degree of standardisation, which led to poor results, mostly due to by lack of the author's previous experience of transfer pricing documentation, Defining which primary sources to use for interviews was not evident until a fair part of the study had been done. The interviewees were then chosen by terms of responsibility. Responsibility of profitability for Customer Segments was a first priority, and in cases where the responsible person was not available someone with relevant insight and responsibility of the segment under review was interviewed.

The authors of the study soon realised that very structured interviews led to poor results. However a fair portion of structure became necessary, especially apparent in sections where all interviewees from the many functions where asked exactly the same questions. Here, the study had asked for quantitative data, however this is merely a way to get an overview of the relationship between Alfa Laval Lund and

³⁶ Sampson 1972 as referred to in Jarratt, (1996), p. 6-15

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Sales Companies. Given the nature of this study some discussion of biased information and the way data was interpreted is included further on in this study.

2.1.5 Methodological Problems

Although suggested sources in the framework seemed uncomplicated, the case specific factors were not. Not only was the process complicated by the number of sources, they often had to be cross-referenced, which was time-consuming.

Some information specifically asked for by the framework was nowhere to be found, which contributed to the assumptions made in the practical appliance of the framework. The result of this study should be valued accordingly. The demarcations in the steps are further addressed in the study.

One surprisingly dominant issue was managing the challenge of explaining the need for questions of a certain nature to the interviewee. The linkage between a transfer pricing documentation and questions of activities and functions was not evident, and the quality of the latter interviews were therefore superior to the early ones as the authors became more familiar with the dilemma.

The extent of the study set limitations for depth in the analysis. The extent of the documentation forced the authors to exemplify two out of nine studied business units. These were chosen on the basis of differences to point out the diversity of sales in the studied company.

2.1.6 Validity

Validity questions the accuracy of the results gained in a study.³⁷ The documentation and this study may both suffer from using a model that is specifically produced for companies in another country as well as it is a few years old. This is however dealt with by the authors by drawing an array of sources as reference for further guidance in using the steps of the framework.

Validity is an interesting dilemma, as a large part of the study is to try and validate the framework for documentation through applying its use in a case study. Although the validity of how that result was reached is important to address as well by addressing the methodology. Factors such as time frame and possibility of source cross-reference has been limited. However, the empirical findings have been examined by higher management which contributes to minimise the risk of biased data. Another problem affecting the validity of this report is that the authors at the same time are the performers of the documentation, which made several parts of the study to analyse the work of one self, something that many times caused confusion and was hard to accomplish.

To further create validity researched sources have been critically examined. An example is how one source used, although dated 2003, state that only few global

³⁷ Arbnor et al., (1977), p. 218

Transfer Pricing Documentation – Putting a Framework to the Test companies follow the transfer pricing regulations.³⁸ The statement is however based on a survey performed by the authors in 1983. Since the global guidelines of transfer pricing by OECD was stated in 1995 and authorities in many countries have stated them by law this information was ruled out as outdated.

2.2 Disposition

The study is presented in three separate chapters that address the study in terms of prerequisites, how the study was put to practice followed by a discussion of factors that affected the outcome and some future aspects. The conclusions are then presented in a separate chapter.

2.2.1 Chapter Three

Chapter three outlines the prerequisites of the study. This is to give the reader an overview of the circumstances for how the model, or framework, was put to use in practice. Thus the micro factors and the macro factors are combined in this chapter.

2.2.2 Chapter Four

Chapter four describes how the framework was used and implemented given the prerequisites. Here the implications of the model are presented for each step, followed by a description of how it was practically done in the company at hand. Both the methodology of doing so and examples of the documentation are outlined. This section is followed by an analysis of the practicality of the step in question. A summary is the basis for some suggestions to the model used.

2.2.3 Chapter Five

This chapter is a discussion following some findings of the previous chapter. The external and internal factors of the study are analysed even more in this chapter. To further investigate the implications of the issue of transfer pricing documentation requirement, some researched literature is used. Chapter four and five jointly point towards the conclusions drawn from this study.

³⁸ Anthony et al., (2003), p. 244

3 The Prerequisites of the Study

This chapter aims to present the practical terms of the case in which the framework is applied and analysed. Given the age and nationality of the framework some additional sources are used for cross-reference. These have also helped provide further guidance on how each approach in the framework can be applied. In addition, this chapter addresses how the chosen company is relevant to the study by putting it in perspective of the background and problem description.

3.1 The Framework

The chosen framework being applied is a model developed by an internationally established consultant firm on the basis of the OECD guidelines. The model is for Danish companies facing documentation requirements. These have been cross-referenced with the proposal for the upcoming regulations from the Swedish tax authority.³⁹

3.1.1 Step One – Market and Business Overview

This section aims to give the reader a brief overview of the company's business sections and the activities on the specific markets under review. A description is made of the group companies markets that have an impact of the group company transactions under review. A description of the main success factors for the group companies market it ensures.⁴⁰

3.1.2 Step Two – Overview of Organisational Structure

This section aims to describe and define the legal and operational organisation of the entities that participates in the group company transactions under review. The definition will simplify the study of the functional and financial analyses. This section will also result in knowledge of how the operational and legal organisations connect to each other and where functions are located operational as well as legal.⁴¹

3.1.3 Step Three – Description of the Controlled Transactions

This section aims to analyse the group company transactions. The transaction flows are divided into changes in ownership; payment flow indicating cash/collections flows from customers and any related parties; and physical flows documenting the shipment of goods between legal entities. In order to clarify which legal and operational entity that takes part in the transaction and how the goods flow it is very important to study and illustrate the transaction flows.⁴²

³⁹ PM Skatteverket

⁴⁰ Danish Documentation Planner, (1998), p. 3

⁴¹ Ibid, p. 6

⁴² Ibid, p. 9

3.1.4 Step Four – Functional Analysis

The functional analysis aims to describe the relationship between the intern group companies. The analysis is a method to relate the concerns business in terms of its functions, risks and intangibles in order to identify where in the organisation they are generated. The purpose of dividing the functions and risks is to confirm whether the result by the entities are appropriate to the performed functions, degree of risks undertaken and the utilisation of the intangible assets.⁴³

3.1.5 Step Five – Financial Analysis

This section aims to show the financial performance of the intern companies involved in the intra-group transactions. The allocation of the intra-group profit and losses is especially of interest. The combination of the result from the financial and functional analysis indicates whether the arms length principle is used or not.⁴⁴

3.1.6 Step Six – Comparability Analysis

The purpose of the comparability analysis is to collect relevant data from similar companies to benchmark with the result from the functional and financial analysis. It will also help to indicate weather the arm’s length principle is applied compared to the companies analysed in this section.⁴⁵

3.1.7 Step Seven – Selecting the Transfer Pricing Method

The purpose of this section is to show the transfer pricing methods chosen for the analysed intra group transactions and describe the motivation of why the methods where chosen.⁴⁶

3.2 Further Guidance for Use of the Framework

3.2.1 Some Valuable Aspects

The OECD guidelines offers great specificity as to transfer pricing methodology, however there is little guidance as to the form the documentation should take.⁴⁷ The type of documentation required depends on the facts and circumstances of the individual case.⁴⁸ Taxpayers applying the documentation package must comply with three operative principles: (1) reasonable efforts, (2) contemporaneous documentation and (3) timely production.⁴⁹ The OECD has during recent years examined profit methods and concluded that both the profit-split method and the transactional net margin method were becoming more widespread.⁵⁰

⁴³ Danish Documentation Planner, (1998), p. 15

⁴⁴ Ibid, p. 27

⁴⁵ Ibid, p. 30

⁴⁶ Ibid, p. 37

⁴⁷ Ossi et al., (2003), p. 289

⁴⁸ OECD Guidelines §5.16

⁴⁹ Ossi et al., (2003), p. 289

⁵⁰ Stanley, (2001), p.25

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The importance of the functional analysis is mentioned in several sources. The framework used states “It is important to note that tax authorities all over the world are relying more and more on the functional analysis. While many countries have developed their own regulations, the value of the functional analysis has been recognised in each instance. It is the one universal transfer pricing concept that all countries agree upon”⁵¹. The Swedish tax authorities agree as a representative claims that the functional analysis is the most important part and of increasing value in evaluating the documentation of transfer pricing within companies.⁵²

3.3 An Empirical Study

To be able to study the practical use of the documentation framework selecting a company was necessary. The company used for the purpose in this study had planned to perform documentation closer to the date of the new Swedish regulations, however in the authors interest of performing this study in 2004 the organisation decided to start this process earlier.⁵³

3.3.1 Choice of Company

Alfa Laval Lund AB is believed to be a representative company for the purpose of the study as the company has many internal international transactions and believe they are an early target for auditing. Alfa Laval Tax Management has followed the developments and believes the organisation is a very likely subject of review in short after the new legislation in 2005. In April 2004 there was a further preliminary indication of the Swedish tax authority focusing on transfer pricing issues as a small number of questions regarding this matter were sent from the tax authority to be answered in April 2004.⁵⁴ Therefore, Alfa Laval Lund AB, hereafter Alfa Laval Lund, was very interested in gaining a documentation of the existing transfer pricing. A decision was made to perform a documentation of financial year of 2003.

Alfa Laval views the transfer documentation as a compliance driven matter. Although most organisational instances agree on this, there are different parties with different interests within Alfa Laval Lund. It is in the interest of the tax management to prove that there are no tax avoidance through transfer pricing and to show this as efficiently as possible to the Swedish tax authorities.⁵⁵ An awareness of cost and resource allocation is believed to have influenced the decision to involve master thesis students rather than internal staff or external experts.

The observation by the authors has led to believe that from an operational point of view Alfa Laval does not see a need for reviewing transfer-pricing. There are among other things recent changes to try and focus on consolidated margins for all profit centres involved and avoid transfer pricing focus.⁵⁶

⁵¹ Danish Documentation Planner, p.15

⁵² Bergqvist, S., 2004-02-18

⁵³ Hermansson, A., 2004-01-21

⁵⁴ Emanuelsson, U. 2004-04-21

⁵⁵ Malmros, J., 2003-01-21

⁵⁶ Sandborgh, H., 2004-03-25

4 Applying the Framework

In the following chapters the practical use of the framework applied in the chosen company is presented. Each of the steps are presented and discussed in terms of approach of the framework followed by examples of how it was practically applied in the studied case. The analysis of each step is summarised towards the end of this chapter, together with suggestions of improvements for the framework used. Finally the major conclusions of this chapter are outlined for a basis of further discussion.

4.1 Step One - Market Analysis

4.1.1 Model Implications

This section should according to the deliverable, i.e. the requested result, identify and describe the key factors facing the group company on the market in which they operate. This includes history on the market, product offerings, competitors and any other important economic factors. The approach that is recommended is for the documenter to include the company's operations and sales, and the major changes affecting them, description of important mergers and acquisitions, description of the company's major product lines and competitors.⁵⁷

4.1.2 Step One at Alfa Laval Lund

4.1.2.1 Step One in Practice

Presentation of market specific conditions was ruled out in the documentation as Alfa Laval Lund sells to 55 different countries with up to eight different active Customer Segments.⁵⁸ For the specific case the presentation of sales through Customer Segments became the natural choice after assessing the data gathered. Presenting product lines or even core products would not be possible for the size of operations of Alfa Laval Lund. Customer Segments however show how profitability is allocated in the concern, which has further impact reporting of costs and how key numbers are presented in the annual report.

There were no major problems in obtaining and presenting the relevant information, the issue became to decide the level of information needed. Further it was hard to extract and select relevant data as many sources contained a lot of information. Further the variety of sources became a problem, with no evident way of telling the most suitable one made the workload higher than previously estimated. This step suffers some confusion due to the large re-organisation in 2001.⁵⁹ This affected how

⁵⁷ Danish Documentation Planner, (1998), p. 3

⁵⁸ Alfa Laval internal reporting lists

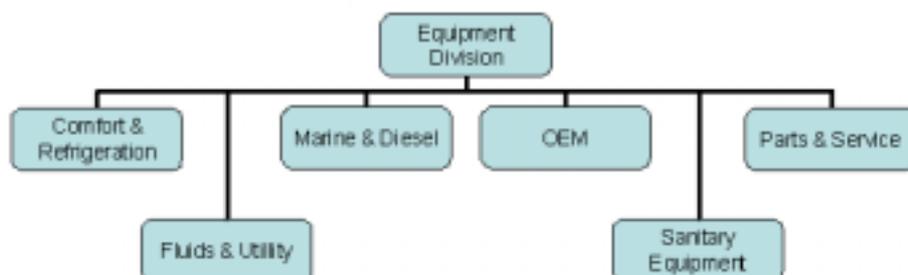
⁵⁹ Alfa Laval, Intranet, 2004-03-10

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 data was presented as many of the sources showed old ways of doing business. This was however not apparent to the authors at this stage.

4.1.2.2 Examples from the Documentation

Alfa Laval Lund AB is part of the Alfa Laval global concern that operates in countries worldwide. Alfa Laval was founded in 1883 and its operations today is based on three key technologies; heat transfer, centrifugal separation and fluid handling.⁶⁰ Alfa Laval has global representation of 20 production sites, 70 service units and sales companies in around 50 countries. There are also other forms of sales representation in 45 countries. Alfa Laval has more than 20 000 customers including BASF, Bayer, BP; Heineken and Tetra Laval.⁶¹ The organisation has approximately 9292 employees worldwide.⁶² The company is divided into two market-oriented divisions; Equipment and Process Technology. While the Equipment Division sells volume products to a price-sensitive market, the Process Technology Division focuses on more customised solutions.⁶³

- The Equipment Division - This division offers a wide range of products for customers that have well defined and regular needs. Sales are channelled through sales companies, distributors, contractors, installers, system builders and OEMs (original equipment manufacturers).⁶⁴



Customer Segments of Equipment Division

Figure 2: Equipment Division, Alfa Laval Intranet, 2004-03-03

- The Process Technology Division
 The division supply unique solutions, which aim to help customers optimise their processes. The division supplies everything from components to systems to and is based on extensive process and production expertise in combination with technology.⁶⁵

⁶⁰ Reidy, (2003), p.5

⁶¹ Alfa Laval Intranet, 2004-02-09

⁶² Emanuelsson, U., 2003-01-21

⁶³ Reidy, (2003), p.5

⁶⁴ Alfa Laval, Intranet, 2002-02-25

⁶⁵ Ibid

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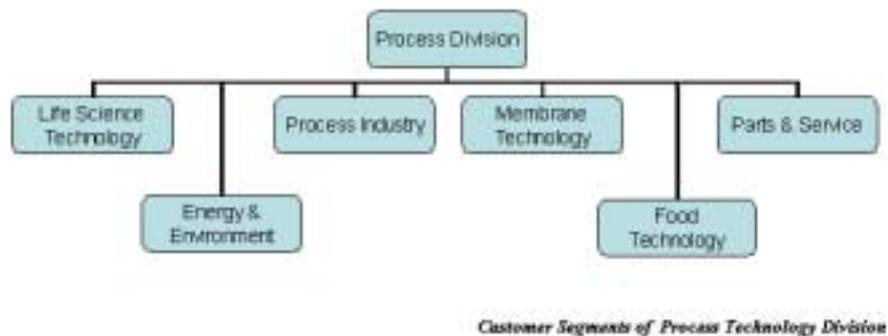


Figure 3: Process Division, Alfa Laval Intranet, 2003-03-03

In turn, these divisions are focused with a number of customer segments. These segments are Comfort & Refrigeration, Energy & Environment, Fluids & Utility, Food, Life Science, Marine & Diesel, OEM and Parts & Service, Process Industry and Sanitary.⁶⁶ The customer segments that allocate revenue to Alfa Laval Lund AB are all but Membrane Technology. Parts & Service segments are everything but new sales and it is the only segment that is represented in both divisions. Alfa Laval Lund has around 1000 employees and all operations concern the business of heat transfer.⁶⁷

* **Comfort and Refrigeration Customer Segment**

Comfort and Refrigeration handles two separate market units, which deal with different customers and application areas. Global Comfort sales are estimated to approximately 70 MEUR per year, of which BHE, Brazed Heat Exchangers, PHE, Plate Heat Exchangers, and air solutions make up 60 MEUR and 10 MEUR are sales of HES, Heat Exchanger Systems. Customers are usually within the building industry. Refrigeration has global sales of 60 MEUR with different kinds of heat exchangers. Majority of heat exchangers are those types that gasketed plates, PHE, cannot handle due to liquids that have high effects on the material, such as ammoniac and Freon. The segment sells to very large clients as well as orders for single products. Price differs with almost a tenth of the price for a large customer for the exact same product. The common features of the two units are selling through channels and increasing focus of finding new sales channels. The segment used to sell by pushing a concept; today there is a more mature market, which has changed focus to price and availability. Competition is increasing; new entrants come into the market all the time, often with niche products and a high capacity to quickly manufacture in a cost efficient way.⁶⁸

* **Process Process Industry Customer Segment**

The applications of the customers in Process Products Industry Customer Segment, or PPI, are usually solutions or processes that handles raw material and do not require producing with results of high standards on the finished good. An example of a

⁶⁶ Reidy, (2003), p.5

⁶⁷ Alfa Laval Intranet, 2004-02-26

⁶⁸ Hellborg, M., 2004-04-19

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customer's business is sugar manufacturing. Heat exchangers make up 80 percent of total products sold through the PPI customer segment. The remaining 20 percent are separators and decanters. AL Lund is the manufacturer of the heat exchangers while the separators are made in Tumba and decanters in Söborg, Denmark. The majority of PPI products are sold to foreign countries; only 3-4 percent is sold within Sweden.⁶⁹

Major changes in sales were documented, such as Customer Segment changes. The Marine and Diesel segment will in short move the manufacturing of heat transfers abroad, affecting revenue allocation to Alfa Laval Lund.⁷⁰ A large part of invoicing to Europe will in short be handled by another legal entity, called Alfa Laval Europe. This will have major impact on how and where allocation of profit will be handled.⁷¹ In addition, the work with a change programme has the intention to increase direct invoicing to end customers.⁷² The presentations of heat transfer technology, as well as trend and competitor analysis were major parts in this step.

4.1.3 Analysis – Step One

The deliverable and approach of this section are argued to be fuzzy and unspecified. It does not give any implications of the "reasonable efforts" suggested by the OECD. Therefore the level of depth and width of this step was a complicated matter to answer. This was not totally clear until sources such as the annual report and revenue reports were dealt with in the following steps.

The ways of selling through Customer Segments were determinants in this case which proves the importance of operational structure in a company. The factors asked for in terms of changes in sales proved to be especially important. Given the requirement of "contemporaneous" documentation the decision to move manufacturing to foreign entities, like in the case of the Marine and Diesel may have great impact on further documentation in Alfa Laval. The reporting and size of operations may change substantially, which in turn affects the documentation.

If similar factors in this step are considerably changed; it would mean that the documentation as a whole would be in need of substantial updating. This means that a good documentation of trends and changes in ways of selling may help any upcoming work with updating a documentation report. It may also have other consequences. For example, if a large portion of change in sales is about to occur, it might be preferable to put the documentation work on hold rather than having to remake the documentation in order for it to be "timely production". The reorganisation affects many steps and is analysed further in later on.

It is in the advantage of the company performing the documentation to consider the degree of "reasonable efforts", "contemporaneous" documentation and "timely production" at this stage in the working process. By making relevant assumptions and

⁶⁹ Krook, R., 2004-03-03

⁷⁰ Jönsson, S., 2004-04-05

⁷¹ Frennfelt, C., 2004-03-11

⁷² Erlandsson, P., 2004-05-06

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setting boundaries, much of unnecessary work can be avoided later on, which will be showed in the following steps. The experience of the study regarding the first step is that it may be hard to separate market analysis from functional analysis as many factors are intertwined.

4.2 Step two – Organisational Overview

4.2.1 Model implications

According to the documentation framework is an illustrative description of both the operational and legal structure of the investigated company and the entities involved in the group transactions demanded.⁷³

4.2.2 Step two at Alfa Laval

4.2.2.1 Step Two in Practice

A lot of relevant information during step four proved to have impact for how to value the results of this step. For example we learned during interviews that the average length of employment in Alfa Laval Lund site is 14 years.⁷⁴ According to this, many of the sources used may have biased views of the current organisation. The problem of producing the real picture of the organisation may further be complicated by the still ongoing organisational changes that also were known during step four. The picture appeared clearer when further interviews had been made which supported the authors with organisational information.

4.2.2.2 Examples from the Documentation

*** Legal Organisation**

The legal organisation describes where legal rights and shareholder responsibilities lies. It also shows the taxpayers who is involved in the group transactions. The legal organisation are presented and described in figure 4.⁷⁵

⁷³ Danish Documentation Planner, (1998), p6

⁷⁴ Bülow, T., 2004-03-31

⁷⁵ Danish Documentation Planner, (1998), p6

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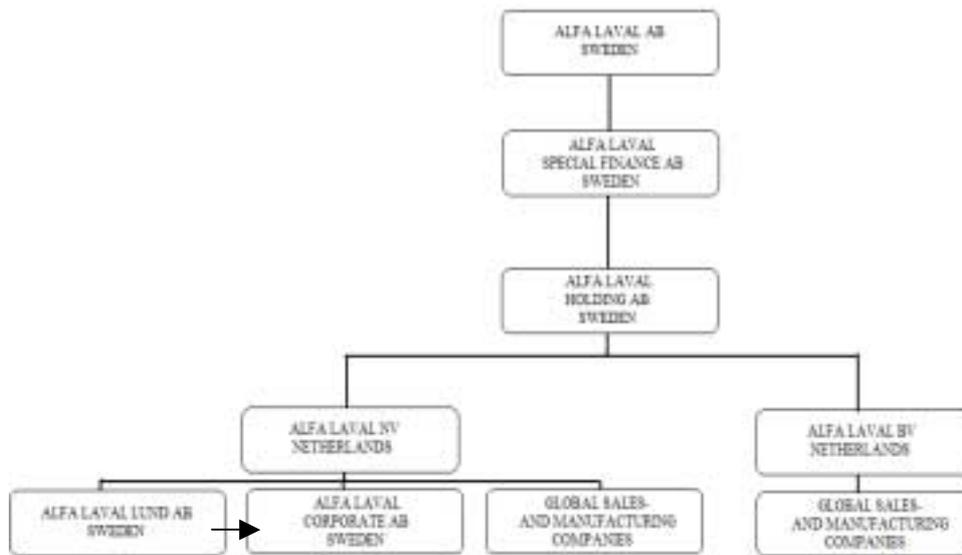


Figure 4: Legal Organisational Structure

Alfa Laval AB is the parent company in the Alfa Laval group. It is incorporated in Sweden as a public company with shares traded on the Stockholm stock exchange. Alfa Laval Special Finance AB is fully owned by Alfa Laval AB and operates as a financial support company to Alfa Laval AB. Alfa Laval Holding AB is fully owned by Alfa Laval Special Finance AB and is the owner of Alfa Laval NV and Alfa Laval BV.⁷⁶

Alfa Laval NV and Alfa Laval BV are holding companies incorporated in the Netherlands. They are fully owned by Alfa Laval Holding AB. The reason why there are two holding companies is that some of the global group companies are by domestic law compelled to have more than one owner. Together Alfa Laval NV and Alfa Laval BV own all global group companies.⁷⁷ The global group companies represent both manufacturing and sales entities. The number of global group companies is more than 110.⁷⁸

Alfa Laval Lund AB is incorporated in Sweden and fully owned by Alfa Laval NV. Alfa Laval Lund AB are a commissionaire to Alfa Laval Corporate AB. Alfa Laval Corporate AB, which is registered in Sweden are possessor of all assets at Alfa Laval Lund AB. Alfa Laval Lund AB does not have any subsidiaries.⁷⁹

* Operational Organisation

A figure of the operational structure of Alfa Laval can be seen in the Market Overview. The two business divisions, Process- and Equipment division each have a

⁷⁶ Ngo, Y., 2004-03-04

⁷⁷ Ibid

⁷⁸ Alfa Laval annual report 2002

⁷⁹ Ngo, Y., 2004-03-04

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Product Management unit and a Research & Development. There is also Operations which is regarded as a division on its own concerned with heat transfer technology.⁸⁰ Operations is divided into three parts; Manufacturing, Logistics and Purchasing, where the manufacturing is the major part. Logistics is divided into shipping and DC (Distribution Centre). Shipping handle the management of freight contracting and the DC manage the function for keeping products in stock. There are three DCs for heat exchangers world wide, one for each global market. These are DC Europe, DC Americas and DC Asia. One part of DC Europe is established in Lund and is legal a part of Alfa Laval Lund AB.⁸¹

4.2.3 Analysis of Step Two

4.2.3.1 General Aspects

It is evident that the framework aims for the documentation to describe both the operational and legal organisation in the concern, and point out the differences between them. However the transfer pricing regulations focus solely on the transactions between legal entities and Alfa Laval operates in the interest of the operational organisation. The differences between the operational and legal organisation are endless which have affected the difficulty of the documentation in this step as well as the following. To receive a clear understanding of the intern transaction flow in the concern further on in the documentation the authors believe that a clear picture of the two organisations is of great importance, however reaching it may take both time and critical review of data.

The step of providing overview of the organisational structure would also benefit from including interviews in the approach. To gain an even clearer picture, and to help explain complexity of activities in step four, the Functional Analysis. This step would also benefit from including information regarding ongoing organisational changes.

4.2.3.2 Legal vs. Operational Organisation

The organizational section shows that it is very hard to separate Alfa Laval Lund from the concern Alfa Laval in addressing transfer pricing. The operational demands are focused with the concern as a whole and the transfer pricing strategy is not a decision solely concerned with the strategies of Alfa Laval Lund. This makes the study focus with the organisation of Alfa Laval throughout the study. The dilemma of legal and operational organisation caused issues in the following documentation steps as well.

⁸⁰ Alfa Laval, Intranet, 2004-03-02

⁸¹ Florentzson, Å., 2004-03-02

4.3 Step Three – Description of Controlled Transactions

4.3.1 Model implications

According to the documentation framework each flow of transactions should be described. It is recommended to include physical flow, flow of payment and flow of legal title when describing the group transactions. The group transactions should be placed together in a list in which a dividing of the sub groups of the different transactions are stated. The transaction flows under review are also supposed to be illustrated in flow charts.⁸²

4.3.2 Step Three at Alfa Laval

4.3.2.1 Step Three in Practice

The group transactions from Alfa Laval Lund exceeded to approximately 60 000 during 2003. All outgoing transactions from Alfa Laval Lund of 2003 were presented in two internal reporting lists. One list described the transactions of the tangible goods and facts such as amount, receiver, item number, product group, segment group and a brief description of the goods. All the information that was relevant for the documentation was stated on the transaction list of the tangible goods. The other list contained all transactions from Alfa Laval Lund during 2003. The only description of cost centre was for the services invoiced from the IT department. All other information of transactions of services and intangible goods were allocated at the cost centre of various transactions.⁸³ The documentation for Alfa Laval Lund concerns tangible goods exclusively as intangibles and services are not represented by single transactions.⁸⁴

The possibility of defining services and intangible goods was fair in the absence of relevant information connected to the specific transactions. To receive the necessary facts of the transactions describing services and intangible goods further interviews has to be made. Demarcations were made in dividing the transactions into types of goods and group legal entities. The decision was reached not to penetrate the transactions deeper as the importance is to study the sum of the transactions for the specific type of goods. Another possibility that was ruled out was dividing the transactions in Customer Segment per group company, which would result in a list of over 5000 posts. This is argued to obstruct the possibility of overview for a general picture.

For the listing an attempt was made to divide the transactions in product group per internal international entity. This was not manageable as the amount of transaction groups would result in an amount of 10 000 groups of transactions. After interviewing employees from the majority of the Customer Segments the relevance of dividing the transactions into product group level was questioned. We discovered that the flow of products differed between the segments and not within the segments. The group

⁸² Danish Documentation Planner, (1998), p. 9

⁸³ Internal reporting systems, 2004-03-02

⁸⁴ Ibid

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 transactions were divided into two categories; group company and type of goods. An example of the listing can be seen in Appendix B.

Given the above circumstances, for the illustration of transaction flows, the choice was made to describe sales transactions by mapping this out for each Customer Segment. The Segments where the transaction flows do not differ from the general case was described in a common figure (see Appendix A). The same procedure was used for description of services and intangible goods

4.3.2.2 Examples from the Documentation

* Comfort and Refrigeration Customer Segment

The heat exchangers that are manufactured in Lund for Comfort and Refrigeration are distributed by Operations, both through Manufacturing and the Distribution Centre though the majority of the capital value is distributed directly from Manufacturing.⁸⁵

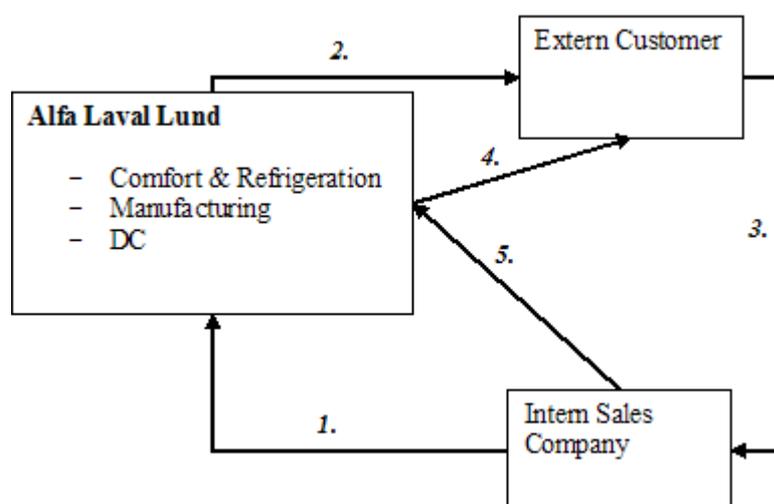


Figure 5: Transaction Flow for Comfort and Refrigeration

Step1: The intern sales company confirm an agreement with the extern customer and places an order at the Distribution Centre if the product is held in stock. Otherwise the order is placed at Manufacturing in Alfa Laval Lund.

Step2: Operations (by Manufacturing or DC) ships the product to the extern customer.

Step3: The external customer pays the sales company of the negotiated amount.

Step4: Legal title passes from Alfa Laval Lund to the extern customer.

Step5: The sales company pay Comfort and Refrigeration at Alfa Laval Lund the transfer price of the product.⁸⁶

⁸⁵ Hellborg, M., 2004-04-14

⁸⁶ Hellborg, M., 2004-04-14

*** Process Process Industry Customer Segment**

The flow of transactions where intern sales companies are involved for PPI is described below.

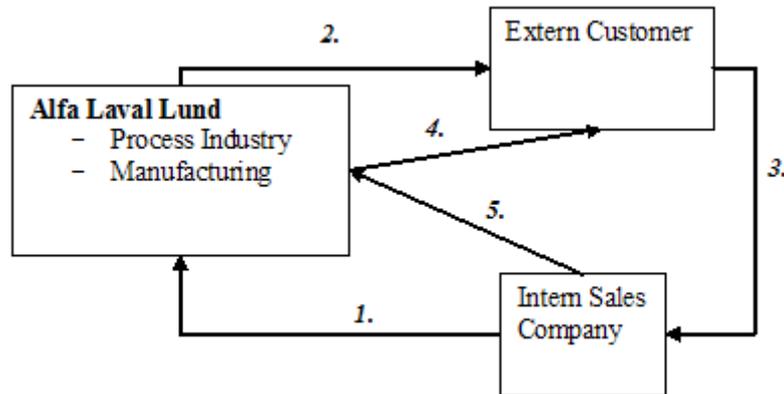


Figure 6: Transaction Flow for Process Industry

Step1: The intern sales company confirm an agreement with the extern customer and places an order at Manufacturing at Alfa Laval Lund.

Step2: Operations (by Manufacturing or DC) ships the product to the extern customer.

Step3: The external customer pays the sales company of the negotiated amount.

Step4: Legal title passes from Alfa Laval Lund to the extern customer.

Step5: The sales company pay Process Industry at Alfa Laval Lund the transfer price of the product.⁸⁷

4.3.3 Analysis Step Three

The documentation results of this step at Alfa Laval Lund shows how customer segments can differ substantially from one another. Flows can be dependent on terms of sales, sales channels, which are important to point out in Functional Analysis.

The internal reporting systems of the company were highly essential for the documentation of this step. How data is gathered and presented is very much controlled by operational standards in the studied company. The approaches suggested by the framework were of little guidance, causing the trial and error process and made the workload quite high. Especially the use of interviews to verify the gathered material turned the working process into a nonlinear road of reaching the desired result.

The authors find that the need for this section is valid for gaining further knowledge of the flow of material and transactions; however some of the requested documents

⁸⁷ Ibid

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send unclear messages. The purpose of the listing is argued to be vague. In the documentation framework there is no real justification for including the listing of the group transactions described except that it is necessary for analysis in the report. The value of the listing is argued to be to receive the information of what proportion the tangible goods, services and intangible has of the total sum of the transactions. In the authorities perspective it may be more effective to first analyse the proportion of the different types of transactions. If interest is found in a specific type of transactions a list of all transactions in the demanded group could thereafter be received from the entity in question. To list all the transaction groups for each country makes the list quiet detailed and difficult to receive a clear overview of the documented transactions. The authors believe this would rather confuse and make evaluation of the documentation complicated for tax authorities than support the knowledge and understanding of the company under review.

The purpose of this step can be discussed in several aspects. Understanding the parties involved and outlining differences in various ways of selling can argued to be important. In the case of Alfa Laval this is done through Customer Segments, which provide better understanding of the complexity of operations that can be valuable for the tax authorities to learn from. It is however the belief that the workload of delivering the maps and the listings is too high in relevance to the benefits gained for the result of the documentation, with reference to "reasonable efforts". The real value in the work of determining transfer pricing methods is argued to be vague. The framework would therefore benefit from having different approaches for small and large size operations.

4.4 Step four – Functional Analysis

4.4.1 Model Implications

In the paragraph "Deliverable" it is outlined how the section should provide a description of the functions performed, the risks assumed and the intangibles owned or used by each of the group companies. It should also identify the relative importance of these elements in terms of contribution to the success of the group's business.⁸⁸ According to tax expert consultant it is important that costs for functions that are not considered in pricing and margins are excluded in the documentation. Further it is important to show the relevant allocation keys for the functions which costs will be allocated to profit centres.⁸⁹ The questions outlined in the framework address the way activities are performed and the relative proportion of activities and risk allocated to the parties involved in the controlled transaction.⁹⁰

The approach recommended in the framework suggests data gathering through interviewing key personnel from all the entities involved in transactions. These can be

⁸⁸ Danish Documentation Planner, (1998), p.15

⁸⁹ Ekelöf, U. 2004-03-25

⁹⁰ Danish Documentation Planner, (1998), p 15

Transfer Pricing Documentation – Putting a Framework to the Test done by using the help of standardised survey questions included in the model. These are mainly constructed through the following manner:⁹¹

“Who performs the strategic marketing function?”

With the choice of ticking one of the following or both:

Manufacturing entity

Foreign entity

These are however to be seen as a basis for discussion, and the questions should not be seen as necessary in absolute terms and be adapted to the specific case (Questionnaire see Appendix C).⁹² The approach also suggests a so called “Star Chart”. The Star Chart is a way to summarise of the findings of the interviews. These are presented with a weighting of the value of the activity performed or risk (1-5). An estimation of the general case which aims to answer who performs the activity and who bears the risk, this is showed by dividing six stars between the seller, for example manufacturing entity, and the buyer, for example a foreign sales company.⁹³

According to a tax expert consultant who has performed documentation of transfer pricing in companies the request of contacting sales companies in other countries have been excluded in every case.⁹⁴

4.4.2 Step Four at Alfa Laval

4.4.2.1 Step Four in Practice

To gain information from sales companies was excluded because of evident lack of time and resources for the many companies involved. The Customer Segments was chosen to be the right level of gathering data to fulfil “reasonable efforts”. This was also decided on the basis of providing the reader of the documentation reasonable overview of activities and functions. As Customer Segments were determinants, personnel working within these functions were interviewed. Although most of the interviewees were legally employed in Alfa Laval Lund, they work with global perspectives of operations.

Here the real issues of excluding one legal entity in a large and complex organisation became very clear. Functions are as seen organised in terms of global operations, and activities and functions are hard to extract in a legal sense. This may have caused the validity of the information gathered, as managers tend to think in global terms. To gather result on the basis of interviews in Star Charts was ruled out. As time and resources only made one interview per Customer Segment possible and the interviewee was therefore asked to provide the data for the Star Chart. Especially for the weighting of the functions this was a manageable approach.

⁹¹ Danish Documentation Planner, (1998), p.15 -17

⁹² Ibid

⁹³ Ibid

⁹⁴ Ekelöf, U., 2004-03-25

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Some observations include that interview information generally had a better quality when the interviewee had direct responsibility of reporting to the Alfa Laval Lund controllers. This was mainly in terms of gaining information in line with the aim of the documentation. Biased data may be included when the responsible person could not attend and the interviewee was someone with a certain niche focus within that market segment. The working process was complicated by the fact that the authors were not aware that product and segment responsible did not always have the relevant information of where functions are performed. This made it important to gather data from people within the corporate organisation as AL Lund is not the parent company.

4.4.2.2 Examples from the Documentation

*** Central Functions of Consideration**

There are a number of services performed by the legal entity Alfa Laval Corporate. These costs are invoiced to Alfa Laval Lund and other legal entities around the world. The services are patents, communication costs, insurances, trademarks and treasury that include financial services such as interest rates, warranties and currency insurance. Management fees are a cost that is not invoiced. Both Alfa Laval Lund and Alfa Laval Corporate are included in the same Swedish tax subject. The pricing of these services are based on market prices, however this is considered to be irrelevant for further analysis in transfer pricing documentation for Alfa Laval Lund.⁹⁵

IT and R&D functions are partly legal entities of Alfa Laval Lund, which makes these services highly relevant to this transfer pricing documentation. R&D services are portioned in accordance with a cost-sharing principle in accordance to what extent group companies in the concern are considered to benefit from these services.⁹⁶

*** Intangibles**

Unpatented technical know how that may enhance cost exists within all AL Lund functions, not only the R&D function. For example this is very important within the market segment activities, which the seller usually contacts for decisions of which product or solution that should be offered to the client. There may be agreements in terms of licenses for products that are sold through Alfa Laval Lund, but manufactured by an external party. These agreements are however not likely to have any substantial costs. Patents are seen as an R&D cost within Alfa Laval, however some people may argue it should be allocated as a marketing cost. This way it is clear that the activities are solely done at AL Lund, and the sales companies play no part in the process. R&D expenses are portioned out to the customer segments by using specific allocation keys.⁹⁷

⁹⁵ Malmros, J. 2004-03-29

⁹⁶ Ibid

⁹⁷ Andersson, J., 2004-03-08

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Trademarks are seen as marketing expenses. Although trademark activities are important, there is no known case of an external party trying to copy the Alfa Laval trademark.⁹⁸ Some sales companies, especially in the US, have trademark expenses. For example it is very important to be able to produce photographed material of branded products for some authorities and especially patent decision makers.⁹⁹

* **Marketing and Communication Services**

Overall strategic marketing is a central function. After the reorganisation in 2001 a function named Marketing and Communication was centralized to one global unit under corporate communication serving the whole concern. There are formalised ways of controlling the marketing function, which leave a few options for the sales company to decide for themselves.¹⁰⁰

The marketing material for Equipment division is produced in Lund and Tumba. Sanitary, Comfort and Refrigeration and OEM are invoiced from Lund and Marine & Diesel and Fluids & Utility are invoiced from Tumba. Activity plans are set up with special key drivers, which form the main strategy. The market segments have activity budgets, which sets the limits for their marketing actions. The sales companies compile a “wish list” of marketing activities and material for Market & Communications to decide whether it is possible or not to manage.¹⁰¹

To have a central marketing function generates many advantages but also many issues and high costs. Mostly due to the high supply costs and the inconvenience and long delivery time there are discussions of moving printing to more local areas. At every forecast are prices set for all market activities. The brochures are invoiced to the ordering sales company of a price below the fabrication cost. The cost for market shows is split up between the sales companies (60 percent) and the central market (40 percent). The remaining central, total costs are invoiced to the market segments through a central discussion and allocation keys.¹⁰²

Challenges for the Market and Communications function are amongst other to try and focus on certain campaigns, geographical markets or products one at a time. Today a common situation may be that a sales company is pursued by several central market segment functions to engage in marketing at the same time. This makes it hard for many sales companies to cope.¹⁰³

* **IT services**

Corporate IT (CIT) is a fairly large function within Alfa Laval and has around 150 employees of which 50 percent of employees belong to AL Lund AB. All services, whether it concerns performing it or hiring external consultants for a project, are filtered through CIT for cogency purposes. The reorganization in 2001 has meant

⁹⁸ Andersson, J., 2004-03-08

⁹⁹ Sandborgh, H., 2004-03-25

¹⁰⁰ Isacsson, E., 2004-04-06

¹⁰¹ Ibid

¹⁰² Ibid

¹⁰³ Isacsson, E., 2004-04-06

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 hard work for IT with trying to slim down the number of systems used, find the most valuable ones and work with implementing them around the world. This process is still ongoing at a smaller scale.¹⁰⁴

Sales companies normally have one or two employees to deal with IT in relevance to the size of the company. These employees are not included in the IT organization presented here. They do however communicate and receive directives from Corporate IT, regarding system updates and other guidelines.¹⁰⁵ The local IT teams are usually concerned with day-to-day problems with personal computers.¹⁰⁶

IT is centralised function within AL Corporate, however the majority of employees belong to the site in Lund and the majority of invoicing is also handled by Alfa Laval Lund.

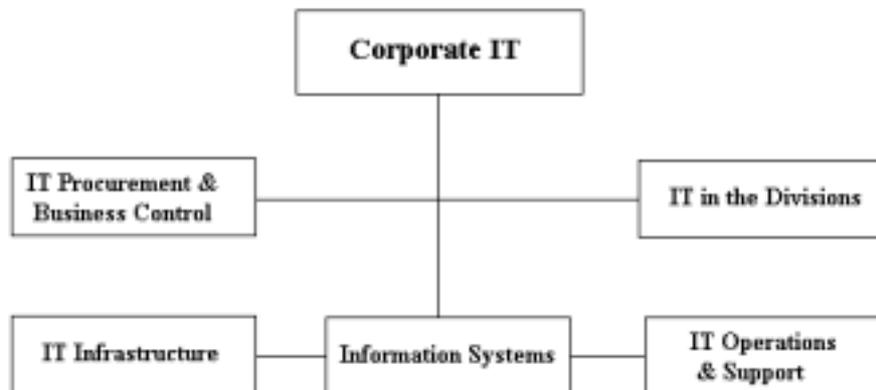


Figure 7: IT Services Operational Organisation, Alfa Laval Intranet, 2004-03-17

IT Procurement and Business control handles all sourcing and purchasing, and negotiate deals for the organization as a whole. Central license agreements are negotiated centrally, and invoiced in regards to how many are being used at each site without any profit mark up on the price. *IT Infrastructure* works with global Alfa Laval solutions for bandwidth, networks, hardware and software, upgrading and testing. Every group company is charged with an IT Infrastructure fee from CIT, which is a fixed amount divided at a relevant percentage. *Information Systems* work with solutions for all operations. The cost is normally charged by man-hour spent in. In projects there is total allocation to the specific client, for example if a group company in Italy orders a specific IT service. How other costs are allocated is presented in *IT in the Divisions*. Operational needs are organized within seven different departments. *IT Operations & Support* offers daily support to the Lund, Ronneby, Tumba, Kolding and Söborg sites. There is also a department called Global IT Services, which supports global servers and connections (Internet, e-mail

¹⁰⁴ Bülow, T., 2004-03-31

¹⁰⁵ Ibid

¹⁰⁶ Alfa Laval, Intranet, 2004-03-17

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etc.) This means team members have to be on call day and night to support business hours around the world. *IT in the Divisions* are responsible for coordinating and allocating cost for the divisions: EQD, PTD and Operations. This is portioned out on the market segments in a cost sharing agreement. This function also performs budget and forecast for each segment within the divisions. IT has central negotiation of windows licenses to achieve volume discount. Thereafter the costs are allocated in accordance with number of users, as well as central administration and costs that are divided according to a cost-sharing principle.¹⁰⁷

The new Alfa Laval organisation from year 2001 meant new contact ways to IT for the line organisation. Instead of contacting the personnel in Corporate IT directly, they should use more formal ways, which is not always the case. Corporate IT services have a target of reaching a balance of zero profit or loss.¹⁰⁸

¹⁰⁷ Bülow, T., 2004-03-31

¹⁰⁸ Ibid

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*** Comfort and Refrigeration Customer Segment**

Here follows the functional analysis of the Comfort and Refrigeration, or ECR, Segment, which includes the “Star Chart” that was filled out by a top manager in this Customer Segment.

Function	Priority (1-5)	Alfa Lund	Laval AB	Market company
1. Product and manufacturing				
R&D and technology	3	*****		
Product strategy and design	5	*****		
Manufacturing process design & know-how	3	*****		
Purchasing	5	*****		
Internal logistics	4	*****		
Production equipment	3	*****		
Fabrication and assembly	5	*****		
Packaging and labelling	3	*****		
Quality control	3	*****		
Outbound logistics	5	*****		*
2. Marketing, sales and distribution				
Marketing strategy and development	4	****		**
Sales and pricing	5	**		****
Order processing	5	****		**
Distribution network	5	**		****
Installation and after-sales service	3	*		*****
4. Risks				
Market risk	2	***		***
Product liability	2	***		***
Warranty	3	**		****
	Total	Alfa Lund	Laval AB	Market Company
Number of stars (weighted)	68*6=408	306		102
Number of stars (percentage)	100 %	75 %		25 %

Chart 1: Star Chart, ECR, Hellborg, 2004-04-19

Customer Support: The ECR segment is the one of the most profitable segment within Alfa Laval. One reasons for this are fairly simple product solutions. The team does not have to engage in a lot of calculating activities to find the proper dimensions for products and combined product solutions for customers. Recent years the focus has been on developing sales tools for sales representatives to be able to make

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decisions on their own. This places a lot less focus on involving the team in AL Lund to help the sales representatives. The focus in the central ECR is to keep on developing these sales tools. The Customer Segment work with cutting product variation, and activities have been done to streamline this strategy. It is now simpler for sellers to make cost efficient suggestions, as lists of A; B and C products have been developed centrally. This is a new way of distinguishing between products. Products in category A means no hesitation and clear sales, while B and C products mean more work with dimensions of the product and also means longer delivery time and a higher price for the customers. ¹⁰⁹

Delivery time may vary quite significantly and is highly dependent on the product ordered. Often size in terms of large, small and medium can help estimate delivery time. This is of further help for sellers to make accurate decisions. There is still a lot of focus on developing sales tools, and recent years of investing heavily in this strategy is now starting to pay off by decreasing need for sales support from central market activities. ¹¹⁰

Customer Relations: As in most market segment central ECR only handles customer relations for direct external sales, other sales are handled through sales companies. By the large efforts of developing sales tools sellers are very independent of help from central forces; however communication does occur when sales representatives need help estimating the accurate design, delivery time, price which can be seen as daily support. However feedback of need for or changed sales tools also occurs. For large a project that means higher sales, such as 50' EURO or projects that involves several market companies the central ECR segment may be involved in sales activities. ¹¹¹

¹⁰⁹ Hellborg, M., 2004-04-19

¹¹⁰ Ibid

¹¹¹ Ibid

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*** Process Process Industry Customer Segment**

Here follows the functional analysis of the PPI segment, which includes the “Star Chart” that was filled out by a top manager in this Customer Segment.

Function	Priority (1-5)	Alfa Lund	Laval AB	Market Company
1. Product and manufacturing				
R&D and technology	5	*****		
Product strategy and design	5	*****		
Manufacturing process design & know-how	5	*****		
Purchasing	4	*****		
Internal logistics	2	*****		
Production equipment	3	*****		
Fabrication and assembly	3	*****		
Packaging and labelling	1	*****		
Quality control	3	*****		
Outbound logistics	2	*****		*
2. Marketing, sales and distribution				
Marketing strategy and development	5	*****	**	**
Sales and pricing	4	**	****	****
Order processing	2	****	**	**
Distribution network	3	**	****	****
Installation and after-sales service	3	*	*****	*****
4. Risks				
Market risk	4	***	***	***
Product liability	2	***	***	***
Warranty	3	***	***	***
	Total	Alfa Lund AB	Laval AB	Market Company
Number of stars (weighted)	59*6= 354	272		82
Number of stars (percentage)	100 %	77 %		23 %

Chart 2: Starchart, PPI, Krook, 2004-03-03

Customer Relationship: In almost every case the sales companies around the world handle the communication with the end customer. If there is a need for establishing the right solution for a customer the sales representative handles the contact with the PPI segment. In this way the demands of the customer is communicated which must be put in relevance to availability of the products and possible solutions. With this information the product portfolio manager can make the decisions regarding the

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specific solution for that customer. In less than 10 percent of total sales an agent is placed within the country. In these cases PPI in Lund deals directly with the end customer.¹¹²

Order Placing: In 90 percent of the cases the end customer places the order locally, and then orders are placed directly by the sales companies to Operations in Lund. This means orders are normally placed without passing through the Customer Segment function in Lund. The product is produced for further transportation by the logistics or shipping function for direct delivery to the end customer. In very few cases an order is placed directly to the customer segment in Lund. This may be in cases where the customer has developed a personal relationship with key people in Lund that becomes important in placing an order. This is usually when technical know-how plays a large role, as the sales company doesn't know these dimensions of the products or the solutions in most cases. Earlier the degree of standardization within manufacturing has been very low, but messages of more homogenous ways of producing are requested to keep costs low.¹¹³

Customer Support: If problems arise at installation or when the customer's process is running the support is handled in the same order as the sales value chain. In other words the representatives from the sales company tries to resolve the problem first, and if they do not succeed PPI in Lund are contacted who gives instructions to the seller. If the problem still stands, representatives from Lund may have to travel to the location. In most cases people locally handle the problem.¹¹⁴

In claims the first objective is to assess the problem. The claim is sent to the sales company who in most cases can solve the problem on site. If not the product is sent back to Lund for examination. A new product delivery is made if the product is found to have faults caused by manufacturing or R&D, and AL Lund carries the cost.¹¹⁵

4.4.3 Analysis of Step Four

The value of describing activities is interesting. Many of the functions described should provide a basis for justifying profit margins; however the real relative degree of those activities were very hard to document in the suggested approach. The information regarding allocation keys provide some understanding of the relative importance and know-how that affect the outcome of the final products sold. However how this will turn out in numbers is hard to draw conclusions from this analysis.

The information regarding cost-sharing agreements, for example in IT, point towards complicated ways of cost allocation. This may become hard for tax authorities to evaluate in terms of proper margins for the separate legal entity Alfa Laval Lund. Further it may be hard to evaluate the benefit of services provided. Alfa Laval Lund

¹¹² Krook, R., 2004-03-03

¹¹³ Ibid

¹¹⁴ Ibid

¹¹⁵ Ibid

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can argue that services and intangibles with a high degree of know-how can support a higher margin.

The real value of the functional analysis is therefore interesting to address. The documentation at Alfa Laval, given the level of depth, told us much of how the activities are divided among the parties. However, describing the general case became highly problematic. The documented company has, as seen in the two Customer Segments exemplified, not only different sales and ways for handling activities within in different segments. There may also be large differences in orders within the segment.

The complexity of separating Alfa Laval Lund from Alfa Laval is argued to affect the validity of the documentation. This is shown for example by the complexity of separating marketing services operational activities from legal aspects. We hereby note the importance of how legal and operational structures affect transfer pricing documentation.

Monitoring changes as in step one are also important in step four. The identifying of changes within marketing function may affect the cost structure for Alfa Laval Lund. This will probably diminish the cost allocation through the use of allocation keys and need discussions within the central marketing function. Alfa Laval Lund may be asked to present a documentation report relatively quick. For simple updates this work would benefit from keeping track of the interviewees, and keep Star Chart information as well as other documents in an efficient way. Such information may be valuable for "timely production", and should be well documented to help for quick updates to fulfil the demand of "contemporaneous documentation".

In the light of this it is interesting to address the belief that the functional analysis may provide the essence of the study to tax authorities. It is the experience of the authors that such an analysis would have to be performed at a level of great detail to be of value, which would come in conflict with the guidelines of "reasonable efforts". In the Star Chart the general case can be viewed, however there are many examples of different situations where the general case is not applicable.

Interviews during the functional analysis in the practiced case proved to benefit from interviewing the people responsible for reporting key numbers as well as have sufficient knowledge of sales and market company communication. This way time consumption can be minimized and the accuracy of the gathered information may increase.

As seen earlier, many parties agree on the importance of the functional analysis. Although the authors agree with the purpose of including this kind of analysis, the gains of actually performing it must be analysed. As the real contribution must be put in correlation with the findings of the Financial Analysis, these aspects must be put in context of the framework suggestions and the findings of next step. However, it is in this stage fair to say that the authors of this study argue that there is a lack of questions raised in the framework concerning the functional analysis. There is a need

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 for the functional analysis to explain responsibility and decision paths of an organisation in order to get the full picture. This is further discussed in chapter 4.7.2.1 “*Suggestions for Improved Framework*”.

4.4.4 Including Responsibility

The authors were to begin with unfamiliar with the both the company and their existing transfer pricing strategies, decision making and responsibility functions. In the light of this, a decision was made to include additional questions when performing the interviews during step four. This proved to give a large portion of valuable information to this study, and the most valuable is presented here as well as included in the documentation report for Alfa Laval Lund.

* **Product & Market Segment Profitability**

Customer Segments are structured according to various core businesses and their application areas.¹¹⁶ However it is not always logical, for example Comfort and Refrigeration are gathered in one segment in reports, but their product solutions and customers are very different. The only thing the two have in common is focus on sales through channels.¹¹⁷ Product managers are to ensure the profitability of a core product for different customer segments. They ensure the product range of Alfa Laval core products in the division and between divisions. Product Portfolio Managers work with a various products or product solutions for one Customer Segment.¹¹⁸

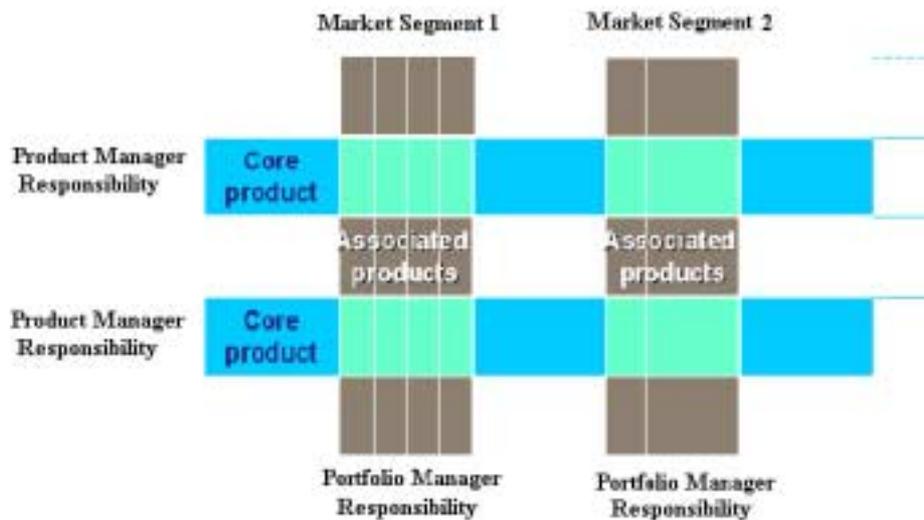


Figure 8: Responsibility Functions for Profitability, Bertilsson, PPT, 2004-03-22

¹¹⁶ Krook, R., 2004-03-03

¹¹⁷ Hellborg, M., 2004-04-01

¹¹⁸ Bertilsson, K., 2004-03-22

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* **Example of Responsibility and Decision Channels**

Product managers are responsible for the market input to R&D and together they coordinate product development needs from the various segments. In addition they handle the interface to Operations. The product portfolio manager is to manage the product portfolio in the Customer Segment. The responsibility includes communicating the market needs and the market developments back into the organization. Further the product portfolio manager must support the market segment in the sales companies.¹¹⁹ The product manager gets data of the demand from the product portfolio manager in each segment, which in turn is communicated to Operations. The product manager analyzes factory cost and be involved in ongoing product care and rationalization projects.¹²⁰

*General Operational Organisation & Responsibilities
Example shows BHE products within Equipment Division*

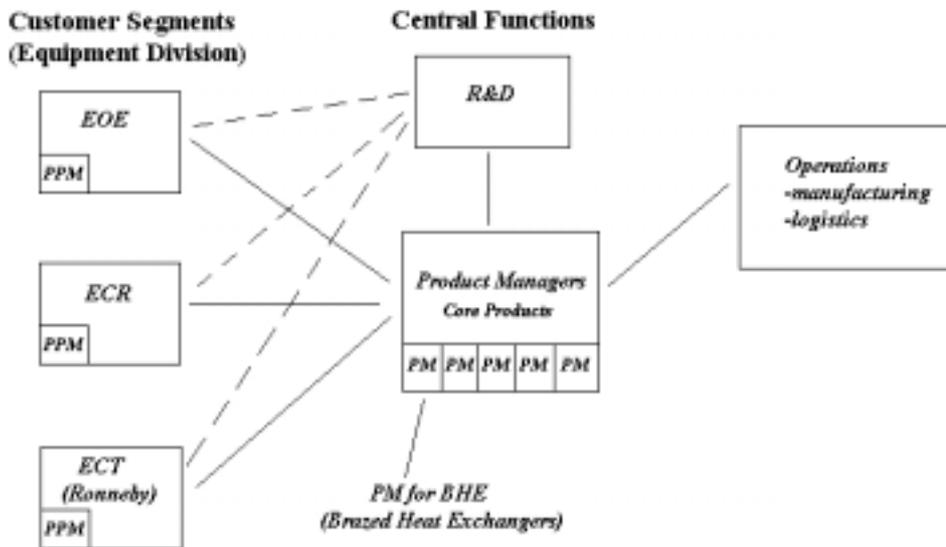


Figure 9: Responsibility & Communication Example, Bertilsson, 2004-04-23

This figure shows the relationships in the general case. In this example Original Equipment Manufacturer, Comfort and Refrigeration and Cetetherm Customer Segments (manufacturing in Ronneby, but legally Alfa Laval Lund) are presented. The product manager works with ensuring the overall profitability for core products within BHE. This is accomplished through gathering all relevant data from each party to be able to set targets for the RCPL (Recommended Customer Price List). There are no general guidelines of setting RCPL. It is the price at the time considered as the highest market price, one that is not likely to ever achieve.¹²¹

¹¹⁹ PowerPoint Presentation, Bertilsson, 2004-03-22

¹²⁰ Bertilsson, K., 2004-03-22

¹²¹ Ibid

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In the figure we can see that the customer segments sell homogenous core products from BHE product lines. These segments also sell products that differ from each other. They all have differentiated ways of selling to their customers. In turn they use different sales and distribution channels.¹²²

* **RCPL, Sales Discounts & Alarm Price**

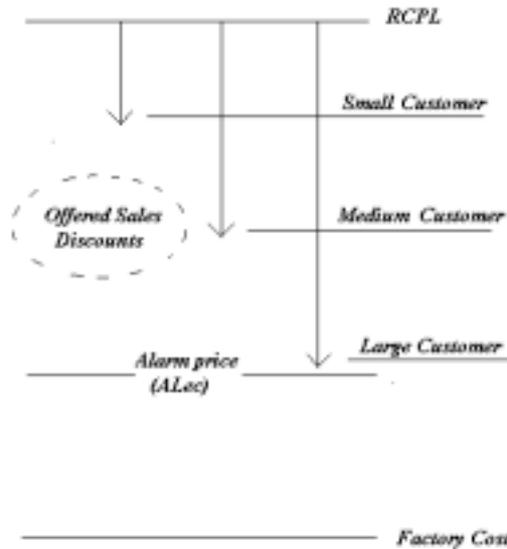


Figure 10: Pricing, Bertilsson, 2004-04-22

The Product Portfolio Manager has the overall profitability within each Customer Segment. The PPM therefore has several core products to consider, and has to evaluate the profitability in regards to the specific customer without losing too much sight of the RCPL set for the products to be sold. The PPM therefore has to recommend the sales discount to the sales companies guided by the RCPL. The collaboration between product managers and product portfolio managers usually provide a basis for the sales discounts that the product portfolio manager can recommend to the sales companies.¹²³

The margin that is allocated to Alfa Laval Lund is alarm price minus the factory cost. The alarm price represents the traditional transfer price. The product portfolio managers are the final decision makers in determining the transfer prices, which is called alarm Price within Alfa Laval. This is a mark-up from the factory cost. The Alarm price is also determined by applying a percentage discount from the RCPL. The further alarm price represents the maximum discount allowed for the sales company to offer.¹²⁴ The sales companies are free to set their prices too the end customer within guidelines from the customer segment. The reason for this is that various markets may differ substantially and it is the function of the sales company to

¹²² Bertilsson, K., 2004-03-22

¹²³ Ibid

¹²⁴ Ibid

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estimate the price sensitivity in the market they are located. The end customer price is not always known to the segment function in Lund; however the product portfolio managers usually have a good idea because of the communication between parties regarding pricing.¹²⁵ Competition may vary for each market and affect the price to the end customer.¹²⁶ Sales companies may have many suppliers; although all are legal entities of Alfa Laval. In terms of choices there is usually one manufacturing entity that produces the good needed.¹²⁷

* **Commissioned Sales & Key Account Managers**

Commissioned sales are sales when the end customer receives an invoice directly from Alfa Laval Lund, and a commission is paid to the seller who handled the customer relation, i.e. the sales company, distributor or agent. The guidelines for setting profit margins are based on the current level used within the Alfa Laval group today, the commission that paid to external agents and distributors as well as what some external companies are using. The following guidelines are acceptable commissions for PPM to distribute to the seller. This margin is relevant as it added to the factory cost represents the Alarm price. The guidelines differ for new sales and after sales:¹²⁸

Spare parts	12 %
Other products	8 %

In addition to these responsibility areas there is another global function that relates back to the business of Alfa Laval Lund. One such important function is handling very large clients, for example Tetra Pak. This is the responsibility of a Key Account Manager who deals with one or a few large customers.¹²⁹

* **Sales and Pricing Dilemmas in Alfa Laval**

Ways of selling are becoming more and more differentiated in relevance to the division, the specific customer segment, and characteristics of the customer - a highly relevant trend for Alfa Laval that offers broad range of solution within both divisions. Alfa Laval has a in this aspect a fairly “heavy” sales organisation, with large overhead cost. No matter the yearly performance of the market company these costs are there. Pihlsgård thinks that Alfa Laval will have a tuff outlook with the current organisation as the ways of selling within the two divisions are growing further apart.¹³⁰ In the current organisations, an example is how the OEM customer segment in the Equipment division is selling increasingly to end customers.¹³¹

¹²⁵ Krook, R., 2004-03-03

¹²⁶ Johansson, H, E., 2004-03-10

¹²⁷ Färemo, U., 2004-04-01

¹²⁸ Malmros, J. “Guidelines for group commissions” 2004-01-06

¹²⁹ Bertilsson, K., 2004-03-22

¹³⁰ Pihlsgård, K-Å.,2004-03-09

¹³¹ Valeskog, A., 2004-02-18

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There may be difficulties in maintaining a targeted margin on sales to group companies. The priority within Alfa Laval is to maintain a cogency price towards the customer, which in turn affects a cogency pricing to group companies in setting the alarm price. For example, degree of allocated R&D as well as prices on raw material and warehousing may vary over time. Further delays, waste in operations and similar factors may all have an affect on the factory cost. To provide a market-oriented price this has an affect on the margin earned on group company sales.¹³² Another important issue for Alfa Laval is the importance to keep cogency towards the customer whit too much focus on cost.¹³³ There may be large variances in cost, for example claims one year can make a substantial contribution to increase cost.¹³⁴ When entering a new market with a high degree of competition the sales company may have to lower its prices substantially to win the customer. This is however an exception to prevent the sales company making a loss and is always a decision after a discussion between the sales company and the customer segment.¹³⁵

Costs and profitability margins are not always easy to explain. Annual reports may show results that are not in accordance with the ideal state of how sales and costs should be allocated within the company. One example of this is when an order is received from a market where no previous sales representation has been established. Alfa Laval therefore has to take an order through direct external sales from the manufacturing unit, even though the cost of sales increases by handling the customer contact centrally. The next year there may have been enough time to establish a sales company or a sales representative, which will show decreased cost for handling sales. This in turn affects the allocation of the margin, external or internal sales, as well as the size of the margin.¹³⁶

* ***Steering Away from Transfer Pricing***

It is the opinion of almost every product manager and product portfolio manager that transfer pries have traditionally caused more cost than value within Alfa Laval. There is rather a focus of steering away from the concept of transfer pricing, as it traditionally has caused a lot of negotiations between parties and led to sub-optimization.¹³⁷ The transfer price has for some time been renamed to alarm price to communicate focus on consolidated margins rather than local. There has already been made changes during 2003 that has put the management control system without any reference to the transfer price.¹³⁸

Since Alfa Laval changed the management control system and stopped measuring performance on local margins there has been a lot less focus on transfer pricing in negotiations with sales companies. Negotiations around transfer prices have only resulted in sub optimisation, and the negotiations themselves have not generated any

¹³² Frennfelt, C., 2004-03-11

¹³³ Ibid

¹³⁴ Erlandsson, P., 2004-05-06

¹³⁵ Krook, R., 2004-03-03

¹³⁶ Hellborg, M., 2004-04

¹³⁷ Frennfelt, C., 2004-03-10

¹³⁸ Bertilsson, K., 2004-03-22

Transfer Pricing Documentation – Putting a Framework to the Test value to the company. The sellers' bonuses are today measured in generated sales divided on sales company cost, which has placed a lot more emphasis on volume and their own cost. Since the new system has been in place, the central segment managers have seen a great deal of change in the behaviour of sales companies and a lot less focus on negotiating for a lower transfer price. Some countries have harder adapting to the new strategy and sellers for example in China still try to negotiate for better transfer prices.¹³⁹

With new changes in the organisation the thought is to change the system to reach direct invoicing from Lund to end customer. This would naturally have wide consequences, especially for the use of transfer pricing in the concern.¹⁴⁰

4.5 Step Five – Financial Analysis

4.5.1 Model Implications

According to the documentation framework the financial analysis is supposed to deliver a model, which show and allocate the profit on the analysed intra group transactions. The model should preferably be developed with figures from the past three years and one or two budgeted years. All countries involved in intern sales should be compared in the financial summary.¹⁴¹

4.5.2 Step Five at Alfa Laval

4.5.2.1 Step Five in Practice

The financial analysis cover the transactions made during 2003. The company does not use ABC and cost allocation is highly dependent on cost allocation guidelines, cost-sharing agreements and similar ways of portioning out cost to Customer Segments as described in the Functional Analysis¹⁴². The choice was made to present the results in two sections. The second section compares the gross margin and gross profit between the countries the business segment sold to. The information of importance in the first section is foremost the Total Gross Profit, Gross Margin and the Operating Result.¹⁴³

The Gross Profit is the difference between Sales (Net invoicing) and COGS (Cost of Goods Sold). The Gross Margin is the margin in percentage between Total Gross Profit divided to Sales.¹⁴⁴ In the Operating Result is the overhead costs considered and subtracted from the Total Gross Profit. The overhead represents Adjustments, Sales costs, Administration costs, and R&D costs and Other costs & incomes.¹⁴⁵

¹³⁹ Sandborgh, H., 2004-03-25

¹⁴⁰ Erlandsson, P., 2004-05-06

¹⁴¹ Danish Documentation Planner, (1998), P27

¹⁴² Interviews, Customer Segments Product Portfolio Managers

¹⁴³ Danish Documentation Planner, (1998), p.27

¹⁴⁴ Emanuelsson, U., 2004-03-30

¹⁴⁵ Internal operating report, Alfa Laval Lund AB, (2003), p2

- Transfer Pricing Documentation – Putting a Framework to the Test
- Adjustments foremost includes exchange differences, calculated claims, currency exchange differences and calculated bad debts.
 - Sales costs include the cost of the business segments personnel, their actions and commissions paid to sales companies.
 - Other costs & incomes represents royalties, rent income, exceptional costs etc.

The second section, the Key Figure Analysis is a comparison of Gross Profit and Gross Margin at group and extern sales between the countries sold to. It is performed in purpose of show the profit and margins for the specific countries. It displays the Invoice value, Gross Profit, Gross Margin and the percentage of the total Gross Profit for each country.¹⁴⁶

The second part of the Key Figure Analysis showing Operating Profit comparison between specific countries was decided not to be included in the Financial Analysis. In addition the separation of intern sales into specific countries in the financial summary was excluded. This because of the difficulties in finding the necessary information of operating margin for each country Alfa Laval Lund AB sold to. Although many suggestions in the framework were excluded this step was time and resource consuming.

4.5.2.2 Examples from the Documentation

*** Comfort and Refrigeration Customer Segment**

As can be seen in sheet 1 Comfort and Refrigeration has a fairly representative part of the total sales to extern customers, 11, 1%. External sales are processed to countries where no sales company or sales agent are represented or when the end customer demand specific solutions, which the sales company can not handle.¹⁴⁷ The gross margin at the extern sales is barely 3% higher than the group sales.

The reason why the operating margin decreased in such proportion from gross margin for extern sales compared to intern sales is that commissions is paid to the sales company in the country in question.

¹⁴⁶ Ibid, p24

¹⁴⁷ Hellborg, M., 2004-04-19

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ECR				
		Total	Extern sales	Group sales
Sales		399916	44595	355321
COGS		-295910	-31860	-264050
Total Gross Profit		104006	12735	91271
Gross margin		26,01%	28,56%	25,69%
Adjustments		26943	2900,90	24042,10
Sales costs		-28897	-10086,28	-25785,72
Administration costs		-2816	-303,19	-2512,81
R&D Costs		-21612	-2326,92	-19285,08
Other costs and incomes		-1507	-162,26	-1344,74
Costs outside factory, total		-27889	-9977,75	-24886,25
Operating result		69142	2757,25	66384,75
Operating Margin		17,29%	6,18%	18,68%
Total assets beginning of the year		27711		
Total assets ending of the year		42221		
Ratio return of assets		197,74%		

Sheet 1: Financial Analysis summary for ECR, values in KSEK. All figures are adjusted by X %.

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* Process Process Industry Customer Segment

As shown in sheet 3 has Process Industry as well as Comfort & Refrigeration a low part of the total sales external by 12%. The Gross Margin is 30, 74% for extern sales and 18, 58% for group sales.

PPI		Total	Extern sales	Group sales
Sales		226042	27100	198943
COGS		-180749	-18769	-161979
Total Gross Profit		45293	8331	36964
Gross margin		20,04%	30,74%	18,58%
Adjustments		17263	1792,59	15470,31
Sales costs		-28943	-3005,44	-25937,39
Administration costs		-2675	-277,77	-2397,21
R&D Costs		-25021	-2598,18	-22422,68
Other costs and incomes		-3884	-403,32	-3480,66
Costs outside factory, total		-43260	-4492,12	-38767,64
Operating result		2033	3838,88	-1803,64
Operating margin		0,90%	14,17%	-0,91%
Total assets beginning of the year		19938		
Total assets ending of the year		14098		
Ratio return of assets		11,95%		

Sheet 2: Financial Analysis in summary for PPI, values in KSEK. All figures adjusted by X %.

According to the Functional Analysis are the weighting of the functions performed at ECR 75% for Alfa Laval Lund AB and 25% for the sales company. In PPI the figures are 77% for Alfa Laval Lund AB and 23% for the sales company. These weightings should be equivalent to the difference in operating margin of internal and external sales from Alfa Laval Lund AB. When studying the financial summary and the financial key figure analysis it is shown that for ECR is the external operating margin 6.18% and the internal 18.63%. For PPI the external operating margin is 14, 17% and the internal -0, 91%. By comparing the results of the Functional Analysis and the Financial Analysis we note that there no similarity between the results within the investigated market segments.

When studying the gross margins for Comfort and Refrigeration in the Key Figure Analysis it can feel quite confusing as many of the margins are not similar to each other when comparing extern and intern sales for the same country sold to. These

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sales often represent a wide difference in volume between intern and extern sales where the fluctuation is high at smaller volumes. As described in chapter 4.4.4 “*Including Responsibility*” there is differences in possibility to achieve flat margins. According to the fact that 10 of the 56 countries ECR sold to represent 64 % of total sales are the markets which represent a fair part of the sales not representative in a general picture of determine the arms length principle. Therefore it is suggested that these ten countries should be of reference when choosing transfer pricing method. The similar principle is representative for PPI where 14 of the 52 countries sold to represent 72 % of the total sales. The higher gross margins that in general capture ECR compared to PPI are appropriate with the description in the functional analysis and confirmed in the financial analysis.

4.5.3 Analysis of Step Five

Given that the OECD guidelines proclaim that the arm’s length principle is dependent on sales prices, margins and comparison of transactions, the financial analysis is undoubtedly important. The need of including the ratio return on assets may however be questioned as well as the recommendation of including all countries sold to in the financial summary. (See similarity between numbers in Financial Analysis and Key Figure Analysis in Appendix B). The authors can hardly see any importance in a transfer pricing perspective of the key number return on assets as it does not affect the profitability. To include all the countries sold to in the financial summary is both a display of partly the same information as in the key figure analysis and makes the analysis indistinct to understand.

The Financial Analysis may be considered as quite detailed and difficult of receiving a general picture of. This because Alfa Laval Lund trades within such a high number of countries. Unfortunately it is not possible to simplify the section because of the requirement that all countries must be displayed. There is no knowing what an analysis of the second part of the Key Figure Analysis in the documentation would have contributed. This can be speculated to limit the Financial Analysis a great deal.

The information outlined in chapter 4.4.4 tells us that the prerequisite differ from each market and that the final market prices of products differ from trade to trade because it is a question of negotiation of discounts with the end customer. In a perfect environment for comparing transactions where extern sales prices are set and the market has no power in negotiate prices would it be appropriate to compare controlled by uncontrolled transactions. Many of the factors revealed in the chapter 4.4.4 such as the “*Sales and Pricing Dilemmas*” reveal the difficulty of this approach, and prove that there is no such perfect environment in the business of Alfa Laval Lund. The price of a product to an external customer is set through negotiation while the transfer price, or alarm price, is set in a more cogency and structured manner. However the market specific conditions, the size of the customer and the order are factors that influence in both cases. This makes it very hard to compare controlled and uncontrolled transactions having further implications for step seven.

In summary the results of the Financial Analysis can only be explained somewhat by the Functional Analysis. The authors argue that understanding the complexity of

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pricing dilemmas is of great essence to the results of the Financial Analysis. As the comparability analysis will be performed in a later stage of the documentation this step is not part of the study, and we move directly to selection of transfer pricing method. Given the tax authority perspective that the Functional Analysis is of great importance, this is questioned when the findings are shown not to be correlated in shown in the financial analysis. There is a lack of guidelines on what legitimate reasons companies can give for showing inconsistent patterns through the documentation. Perhaps the degree of details necessary to understand underlying factors for these results may cause too much burden for companies.

4.6 Step Seven

4.6.1 Model implications - Step Seven

This section should result in a written justification of the choice of the various transfer pricing methods applied within the group company under review. The suggested approach of the arm's length standard is applied by comparing controlled transactions with transactions between uncontrolled transactions based on "economically relevant characteristics".¹⁴⁸ The following is included in the model somewhat, but the authors have chosen to use the source of OECD.

* **Definition of the Arm's Length Method**

A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realised if uncontrolled taxpayers had engaged in comparable transactions under comparable circumstances.¹⁴⁹ In order to be "comparable" to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must only be sufficiently similar that it provides a reliable measure of an arm's length result.¹⁵⁰ To meet the arm's length standard, a controlled taxpayer's results need only be within the range of results determined by the results of two or more comparable uncontrolled transactions. These concepts of results, comparability, reliability, and range are critical to the application of the arm's length standard.¹⁵¹

The OECD Guidelines require the taxpayer to trade with its related parties at arm's length, which refers to the behaviour that takes place between unrelated parties. Taxpayers seeking to create arm's length results within the controlled group may choose from among a set of methodologies set forth in the Guidelines.¹⁵² These methodologies are described below. These can also be found in the framework used.

* **Comparable Uncontrolled Price Method**

¹⁴⁸ Danish Documentation Planner, (1998), p. 37

¹⁴⁹ OECD Guidelines, §1.1 to §1.12

¹⁵⁰ OECD Guidelines, §1.15 to §1.30 and §3.3

¹⁵¹ OECD Guidelines, §1.45 to §1.48

¹⁵² OECD Guidelines

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The CUP Method tests the arms length price for intern transfer of goods and services by comparing the price of an intern transfer to a similar transfer between unrelated parties. The CUP Method has a very high level of comparability. Two factors must be satisfied to consider the transaction comparable. These are (i) the goods or services sold and (ii) the circumstances around the controlled transaction is the same as the uncontrolled transaction. Important factors for determine comparability is; the products and services quality, volume of sales or revenue, the markets level, the geographical market where the transaction is made and the date of the transaction. It is proper with small differences between the compared transactions if adjustments can be made and these adjustments only affect the price by a minor part.¹⁵³

* **Resale Price Method "RPM"**

By comparing the gross profit margin (i.e. gross profit divided by net sales) between a controlled transaction and an uncontrolled transaction is the arms length character tested by the Resale Price Method. Value of functions performed is measured in the method and it is suitable for tangible goods when the buyer or reseller not add any substantial value to the product by physically altering of the product or using marketing intangibles. The gross profit includes return on manufacturing performance, capital invested and assumed risks by the distributor. When using RPM, comparability is important of the similarity of functions performed and risks assumed of the controlled and uncontrolled distributors. The method is not so dependent on the similarity of the tangible goods.¹⁵⁴

* **Cost Plus "CP" Method**

A transfer price in a controlled transaction is compared to the profit mark up on value adding costs that is made in a comparable uncontrolled transaction.¹⁵⁵ This comparison tests the arms length method according to the Cost Plus Method. By the fact that the method measures the value of functions performed at the involved entities it is proper in providing of services to a related party and in manufacturing of tangible goods sold to a related party. The method considers the costs for the supplier of goods (or services) in a controlled transaction to a related purchaser. A cost plus mark up is then added on the costs to make a appropriate profit in contrast to the functions performed and the market conditions. The outcome after adding the cost plus mark up is an arms length price of the original controlled transaction.¹⁵⁶

The mark up on costs provides compensation of both the performance of functions, return on capital invested and risks assumed by the related manufacturer or service provider. The Cost Plus Method is dependent of comparability of similarity of the functions performed at the controlled and uncontrolled parties. The similarity of the products or services is not of great importance.¹⁵⁷

¹⁵³ OECD Guidelines, §2.6 to §2.13

¹⁵⁴ OECD Guidelines, §2.14 to §2.31

¹⁵⁵ OECD Guidelines, §1.25 and §7.36.

¹⁵⁶ OECD Guidelines, §2.32

¹⁵⁷ Ibid

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* ***Profit-Based Methods***

If possible the transaction based methods should be used when testing the arms length character but in some environments is it not manageable. In situations where the comparable uncontrolled transactions needed not is possible to identify or the demanded information of data is not satisfying, profit based methods can be used. These methods are however classified to be used only when the transaction based methods is impossible to apply.¹⁵⁸

* ***Transaction Net Margin Method "TNMM"***

When using the Transaction Net Margin Method the operating profits between the involved parties in a controlled transaction and a uncontrolled transaction in order to test the arms length principle. The compared parties must be engaged in the same type of business for the method should be proper. It is important to measure the operating profit in the most well defined business activities at the controlled entity which has reliable data for review. The comparability is therefore primarily dependent on the similarity of capital invested and risks assumed by the controlled and uncontrolled parties. The grade of similarity between the compared entities may not be perfect. Significant diversity of products and functional differences between the compared parties are acceptable when using the Transaction Net Margin Method.¹⁵⁹

* ***Profit Split Method "PSM"***

The Profit Split Method evaluates the allocation of profit or loss in the controlled units involved in the transactions. One or more transactions are studied and the controlled parties profit or loss is compared to the value of their contribution to the result. The contribution should be arms length due to the profit or loss of the studied parties. The PSM assumes a partnership between the reviewed parties which involve integrated functions that not could be evaluated on separate basis. Independent entities do not ordinarily apply the Profit Split Method except joint ventures. Other methods are in general more reliable for evaluation of the arms length character as the PSM does not evolve external data according to OECD.¹⁶⁰

4.6.2 Step Seven at Alfa Laval

4.6.2.1 Step Seven in Practice

The first decision to make when choosing transfer pricing method is whether a transaction based method or a profit based method is proper for the analysed company. The many business segments of Alfa Laval Lund AB are quite different from each other, as seen in step one and step four, foremost in sales conditions. The methods were examined and excluded by evaluating the criterions of the methods.

¹⁵⁸ OECD Guidelines, §2.49, §3.49, and §3.50.

¹⁵⁹ OECD Guidelines, §3.26 to §3.48

¹⁶⁰ OECD Guidelines, §3.2, - §3.9

4.6.2.2 Examples from the Documentation

As the Comparable Uncontrolled Price Method has priority over the other methods according to the OECD the natural way to start this analysis was by examining the applicability of this method in Alfa Laval first. Because of the complexity of finding extern uncontrollable transactions for profitable comparison this method was hard to apply. Further the profit margins vary for different kind of sales and orders within the customer segments, which complicates the possibility of comparison. Another reason for this method being inappropriate for testing arm's length at Alfa Laval Lund is the level of the documentation. This was set not to examine single transactions for single products, and therefore the possibility to comparison similar transactions was reduced.

The Resale Price Method, which tests the arms length principle by comparing gross margin to extern transactions, was rejected as well. The functions and risks of uncontrolled companies or distributors are not possible to review. In addition the RPM is not appropriate when the purchasing part add value by physical altering or marketing intangibles to the tangible goods which the sales companies in the Alfa Laval group does. Accordingly this method was argued not to be suitable.

The Cost Plus Method is as familiar applicable when the circumstances provides us with data of cost allocation, with a possibility to add a mark-up for sales. Referred to the fact described in the functional analysis that a mark up is made on the factory costs to set the alarm price at the reviewed business segments it coincide with Eccles definition of Cost Plus. The similarity of functions and risks for the companies within Alfa Laval are assumed to be validated, which increase the appropriateness of using the method. However the lack of comparison of how external entities choose their mark ups decrease the reliability of the Cost Plus method as a proper choice. However, by reference to these findings and experiences the Cost Plus Method is the most proper of the investigated transfer pricing methods, although it can not be justified by comparison with uncontrolled sales.

The first profit-based method to consider was the transaction net margin method which was immediately ruled out because of the limitation of reviewing operating profit margins of external companies. Especially in this stage of the documentation where the comparability analysis was not performed this method was not applicable.

The profit split method can be ruled out by the fact that the operating margin of sales companies was not possible to retain. Although the framework suggested including this data in the key figure analysis the size of Alfa Laval Lund operations set boundaries for such an extensive analysis. To analyse the consolidated margins was therefore impossible, which was a prerequisite for this method.

4.6.3 Analysis – Step Seven

The data from using the framework showed that the cost-plus method was the most likely being used in Alfa Laval Lund. However there may be interesting implications by using the additional data presented in Chapter 4.4.4 *“Including Responsibility”*. By examining responsibility patterns and the role of transfer pricing as a management

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tool gave some other implications for the result. The Functional Analysis provided us with some important information regarding to what extent the relationship between central segment activities in Alfa Laval Lund and sales companies, such as the extent to which sales functions and pricing activities are performed. This is however provides little value without putting it in reference to the structure and strategy of pricing decisions outlined in the chapter addressing RCPL and alarm pricing. For example it was discovered that pricing decisions to end customer usually involves high degree of customer segment involvement from Lund. In excluding the profit-split method, it is interesting to examine the reasons more closely. We do note that by providing the information presented in 4.4.3 we know that product portfolio managers usually know the price to the end customer through informal communication with the sales companies. This may very well affect the pricing, especially if the manager decides to focus on RCPL and discounts.

Especially interesting was the information of the RCPL implying a strong market focus within Alfa Laval, and consequently withholding the cogency towards customers. In the light of this many financial numbers can be explained by various degree of competition for different countries.

The authors have found several problems with the transfer pricing methods suggested by the OECD in using them practically. When analysing the transfer pricing methods two major features was discovered. These features are argued to be;

- * A high demand on comparable figures from unrelated parties.
- * Constant margins and sales price of their products.

As the comparability analysis was not included in the study, this is naturally a great limitation to validating the result. However, the comparability analysis is, as seen in chapter three, is described as a benchmark and a way to support possible findings of the other steps of the documentation. This gives the documenter a belief that comparability is to be seen as a complement to other approaches. The comparability between external sales directly from Alfa Laval Lund, was as mentioned earlier very complicated.

The prerequisite of comparability must therefore be addressed. As the second feature proved to be very hard to show through the documentation in Alfa Laval Lund, the first criterion must be questioned as well. Without having a possible mean to extract comparable figures, the comparison itself would be pointless. This criterion is in question by the findings of the previous two steps.

Many indications point towards Alfa Laval having a profit-influenced transfer pricing method in place without fully realising it. The combination of the mark-up and the percentage withdraw from the RCPL show that the cost-plus method is under question. This would further suggest that there may not be one specific method in place, but rather several. These may still fulfil the arm's length requirements.

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Determining the transfer pricing method used can help prove the use of an accepted model by the OECD, however whether the transfer pricing is according to arm's length can in fact only be determined by looking at profit margins. This is not made clear in the framework, and the last three steps described are therefore weak in their relation to each other.

4.7 The frameworks Usefulness in Practice

4.7.1 What affected the outcome?

The chapters analysing the outcome of each documentation step at Alfa Laval Lund must be put in context of several factors influencing the result. Before engaging in this discussion it is important to stress that the findings are based on *one* case of applying this framework in *one* company. In addition there are three aspects singled out as to be of great importance:

- * The experience of the documenters
- * The circumstances of the studied case
- * The constraints of the framework

The first point questions the importance of who performs the documentation. Burke argues that addressing tacit knowledge is highly relevant to organisational consultants.¹⁶¹ The documentation may therefore have benefited by employees performing it, with better and deeper understanding of symbols and organisational language. For example, the extent of the changes made during the reorganisation in 2001 was not apparent to the authors until the primary interviews were performed in step four. On the other hand the documenters are as external stakeholders in the same position as the target audience of the documentation report, and have a better position to identify needs to explain and document to an outsider. This is on the other hand true also for any external consultant, which in addition may have better knowledge of both how to apply the framework and of business processes.

The circumstances of the specific case are highly relevant for the possibility of drawing general conclusions of this study. Companies with similar size and industry may differ substantially in structure of organisation and strategy for sales. However in providing examples for each step the authors believe that other companies may benefit from this study. These are argued to provide further guidance in terms of determining depth and width of the documentation, planning of data gathering as well as examples of format and mode of presentation. Further circumstances were time and resources available for the documentation, which may differ for other companies and affect the documentation.

The constraints of the framework can only be addressed in disregarding the other two dimensions. If we assume that the documenters have sufficient knowledge of producing documentation, and that similar circumstances may exist for companies in

¹⁶¹ Bennis et al., (2003), p. 34

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terms of operational issues, time and resources available, the framework can be criticised in a number of ways. Again, this is explained by pointing out some of the findings of the specific study in Alfa Laval.

4.7.2 Questioning the Framework

With the previous discussion in mind some suggestions of further, future or similar work with this documentation framework can be presented. Some common aspects in the analysis of each step showed clear conflict between "reasonable efforts" and gaining valuable information. On one hand the deliverable of the framework was

4.7.2.1 Suggestions for Improved Framework

Step one proved to be important in terms of changes in sales which affect business structures and the organisation. Therefore this should be highlighted in the framework.

Questions outlining ongoing organisational changes in the concern should be included in the framework. For example such in the case of Alfa Laval where the new legal entity of Alfa Laval Europe will soon take over all invoicing to European countries. This is important to document in step two.

Step three should exclude the listings in the light of poor motivation for the purpose, and no purpose was seen in the result of these listings.

The additional information outlining responsibilities regarding pricing that was gathered became an important tool in order to fully understand the reasons for the results of step four and five and seven. Examples of how central functions are involved given in the Functional Analysis may differ with size of order and from year to year, which can be explained by addressing the dilemmas of responsibility and decision making. In the point "*Sales and Pricing Dilemmas*" we can find many explanations for the results of the documentation.

Step five is in great need of structural changes as it may be hard for a receiver of documentation to get a clear overview. In the approach of the framework there is in part some overlapping information in the result. This has to be put in relevance of the large resource use to produce this analysis.

Proving arm's length can in addition be done by producing documents that support a fair split of profits, such as the reasonable mark-up guidelines document for commissioned sales as seen in chapter 4.4.4. However this would mean a more document specific approach than in the framework used.

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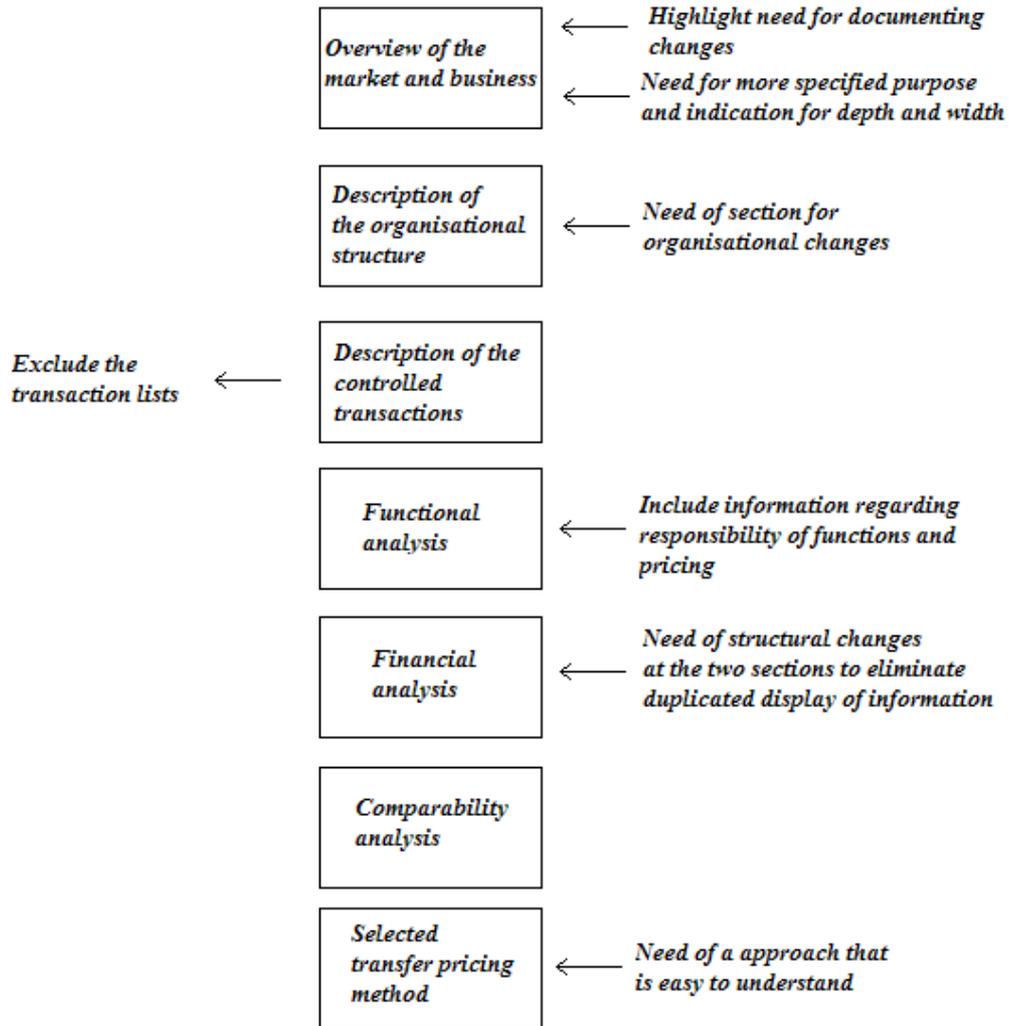


Figure 11: Meta Model of Suggestions for Improved Framework

4.8 Some Conclusions from the Practical Case

To conclude this study has identified two major problems in practically applying a framework for transfer pricing documentation in the chosen company. These are:

- * Transfer pricing dilemmas in the context of operational and organisational demands
- * The use of a standardised framework and models

In the light of these two conclusions, and the fact that Alfa Laval Lund or the concern as a whole may still be in need of transfer pricing documentation, it is argued that the future extent of this issue is of great interest to address.

5 A Basis for Further Discussion

In applying this framework some apparent problems of model appliance and transfer pricing in terms of organisational & operational constraints and have been identified. To further give insight to the dilemmas of transfer pricing documentation these aspects will be addressed by discussing relevant theories. This will be put in reference to the practical use of the framework, but will also be used to draw some general conclusions of the issue of transfer pricing documentation.

5.1 Model Appliance

5.1.1 Models in Theory

Mitchell's definition, a representation of something, is according to David the widest possible definition of a model. Roy is on the other hand more precise in his definition that a model is a schema, a mental or figurative description reduced to essential features having symbolic character. Pidd says that a model is an external and explicit representation of a part of reality as it is seen by individuals who wish to use this model to understand change, manage and control that part of reality.¹⁶² According to Moles models are seen as "sciences of the imprecise" which he elaborates with saying it is always possible to consider a phenomenon, object, human being or message of a limited number of varieties, following certain rules that could collectively be called code or structure.¹⁶³

¹⁶² Pidd, (1996)

¹⁶³ Moles as referred to in David, (2001), p. 460

Source	Definition of Models
<i>Mitchell 1993</i>	<i>A representation of something</i>
<i>Roy 1985</i>	<i>A schema; a mental or figurative description</i>
<i>Pidd 1996</i>	<i>An external & explicit representation of a part of reality</i>
<i>Moles 1990</i>	<i>“sciences of the imprecise”</i>

Figure 12: Definition of Models

Hatchuel (1994) and David (1996) claim that failure of implementation of tools simply arise when actors in organisations and tool designers no longer, implicitly or explicitly, build the theory of the same organisation.¹⁶⁴ David also points out that the interpretation and use of a model will vary according to the dominant logics of the various organisational

factors.¹⁶⁵

5.1.2 Models in Practice

Applying the documentation framework in a company can be seen as a way to implement a standardized model in a specific case. The vague and unspecified guidelines of OECD leave gaps for interpretation. Consultant firms and other stakeholders may use this as a mean to advocate for substantial work with documentation. With the discussion of model definition it is not the intentions of the authors to choose the most fitting definition of the framework used in this study, but rather point out the complexity and wider perspectives to consider in using models. This study has shown a clear interest of consultant firm wanting to promote the development of transfer pricing documentation. This is also evident through some sources where articles are claiming that financial management in companies have too much to cope with and are in great need of experts in the area.¹⁶⁶ These firms have an interest in promoting a large compliance burden, extensive resource use and the difficulty of documentation to promote their services.

5.1.3 Model Appliance at Alfa Laval Lund

The arguments of David (2001) regarding use and implementation of models have been especially apparent and visible in this study. The documentation framework and

¹⁶⁴ Hatchuel (1994) & David (1996) as referred to in David, (2001), p.460

¹⁶⁵ David, (2001, p. 460

¹⁶⁶ See for example: Do the documents right, (2003)

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the case specific factors have many times been in conflict. Assumptions regarding the use of the framework combined with limitations for the specific documentation have therefore been highly important to shape and form the result of the documentation at Alfa Laval Lund.

Companies facing documentation requirements also have to consider the various models within the model. As we have seen in the framework developed by the consultant firm there are models of transfer pricing, modelling and describing transactions, models for functional analysis and ways of modelling financial results. These models are argued to have different levels of being generally accepted. Some of key numbers are easily justifiable, however some may be interpretations and tools developed by the designers of the framework.

5.2 Discussing Transfer Pricing

Transfer pricing is the reason for the of the documentation requirement. If companies did not use international transfer pricing in their operations this study would never exist. In light of the findings of chapter four it may be interesting put transfer pricing in context of its use in companies.

5.2.1 What do Management Researchers Say?

In addressing transfer pricing researchers often talk of business units. A profit organisation usually divides the financial management into three types of financial units of control; the cost centre, the profit centre and the investment centre. In contrast of a cost centre, the profit centre has control over both cost and revenue. Similarly, an investment centre has this control, and in addition control over the use of investment funds.¹⁶⁷ Business unit structures represent trade-offs between business unit autonomy and corporate constraints. The effectiveness of a business unit organisation is largely dependent on how well these trade-offs are made.¹⁶⁸

“The fundamental principle in transfer pricing is that the transfer price should be similar to the price that would be charged if the product were sold to outside customers or purchased from outside vendors.”¹⁶⁹

According to Anthony and Govindarajan transfer pricing should be developed so it accomplish four main objectives:¹⁷⁰

- Each business unit should be provided with the information it needs to determine an optimum trade-off.
- Induce “goal congruent” decisions. Decisions for improvements of the business units profit should improve the company profit.

¹⁶⁷ Smith et al., (2002), p. 485

¹⁶⁸ Anthony et al., (2003), p. 209

¹⁶⁹ Ibid, p. 244

¹⁷⁰ Ibid, p. 243

- Transfer Pricing Documentation – Putting a Framework to the Test
- Should help measure the economic performance of an individual business unit.
 - Should be simple to understand and run.

Further an ideal situation is when the transfer price based on a market price for a similar product or service at an external company. A downward regulation of the transfer price is possible to compensate the actions at the sales company.¹⁷¹ The company should be free to source between internal and external customers/suppliers in which it provides the company's best interests. The transfer price gives the manager of each profit centre a right to trade with either internal or external customers/suppliers. This method is ideal when the selling company are able to sell all their products to an internal or external entity and the buying entity always has suppliers to receive products from.¹⁷²

According to Eccles a Cost Plus mark-up is appropriate for setting transfer prices as an alternative of comparing with external transactions. Similarly Anthony and Govindarajan argue that cost methods are to be used when no competitive prices are available. The transfer price is set by the cost and a mark up of the costs. It is of great importance to define the costs and to calculate the profit mark up. Standard costs are used instead of actual costs, this as an incentive to eliminate acceptance of efficiency loss.¹⁷³

In a perfect situation managers are interested in a short term as well as a long term performance of their responsibility centres. Staff people involved in the negotiation of transfer prices needs as well be motivated and competent.¹⁷⁴ The role of transfer pricing in performance measurement is interesting and note that Ittner and Larcker argues that research is needed on the treatment of the inevitable trade-offs that managers need to make among various financial and non-financial performance measurements.¹⁷⁵

We can conclude that management control experts point towards organisational mechanisms of companies in discussing transfer pricing. Especially the aspect of operational efficiency was noted in the work with Alfa Laval Lund, which brings new aspects of consideration. In addition, other researchers like to raise the complexity aspect. This may be of importance to understand the basis for choices of transfer pricing methods within companies.

5.2.2 Addressing the Complexity of Transfer Pricing

In touching upon ideal circumstances and situations for transfer pricing it is important to relate to real business situations. Boyns et al concludes that our understanding of the determinants of the choice of transfer pricing is patchy. Mathematical, economic,

¹⁷¹ Anthony et al., (2003), p246 -248

¹⁷² Ibid

¹⁷³ Ibid

¹⁷⁴ Ibid

¹⁷⁵ Ittner et al., (1998) , p. 229

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behavioural, organizational and other approaches may have contributed to the lack of clear understanding of the choice of method due to their diverse underlying assumptions.¹⁷⁶

Methods and theories that seek to describe or predict the method of transfer pricing, often in terms of cost versus market, are typically based on organizational contextual factors. These factors may be in terms of structure, vertical integration and diversification, strategy, group company transactional context and control systems. These approaches are based on two assumptions. Firstly that transfer pricing choice and change can be understood through contingent relations with contextual factors found in the economics of internal organisation and transaction cost theories. The second assumption is that transfer pricing is determined by those factors, strategy and structure in particular.¹⁷⁷ However, research such as van Helden et al (2001) also point towards factors or history and organizational learning is important to understand what has shaped the development of the transfer pricing system over time, and that there has been a lack of such research.¹⁷⁸

5.2.3 Alfa Laval and Management Perspective

The author's definition of Alfa Laval Lund is an investment centre, while the buying entities are seen as profit centres. Before discussing whether the performed documentation can validate the transfer pricing methods in place at Alfa Laval the term "ideal" should be examined. We have learned what the OECD agree with many researchers in the way that the arm's length supports the same pricing to external parties as well as to internal. In knowing that the transfer pricing method used in Alfa Laval is mostly argued to be the cost-plus method, this method is interesting to discuss. It seems that the traditional cost-plus method did not include any component of comparability. However in the guidelines issued by OECD they promote this as a rather large component.

It is interesting to test the theories of the ideal situation according to management control experts. This can exemplify the complexity of transfer pricing in a company such as Alfa Laval. It is fair to say that the previous transfer pricing strategy used in the company did not support goal congruence. This made it unfit for a control mechanism for increased profits. However the new strategy is rather to exclude transfer pricing than use it as a tool for measuring performance of individual business units. In reference to Ittner and Larcker this may simply be one of the trade-offs that the company has been forced to make in choosing their financial performance measurements. This also implies that the transfer pricing at Alfa Laval is not always simple. Although this may have to do with the diversity and various market factors of the business rather than the strategies themselves. The two-fold view of market and costs however suggests some confusion in transfer pricing strategies.

¹⁷⁶ Boyns et al., (1999), p.85

¹⁷⁷ Perera et al., (2003), p. 141

¹⁷⁸ van Helden et al., (2001), p. 383

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The suggested ideal situation according to transfer pricing experts, among other things involves the freedom to source. In the studied company Alfa Laval, the sales companies buy exclusively from the manufacturing entity and transfer pricing is therefore not used as a way of reaching efficiency through pressuring internal selling entities with threats from external competition.

As Ittner and Larcker suggest there is no optimum found in the making of operational performance measurements, however transfer pricing is today chosen by Alfa Laval not to be a tool for such measurement. This approach makes it interesting to shed some light on the fact that the documentation requirement can be viewed as a new external demand. This demand puts focus on the very thing the organisation tries to avoid; transfer pricing negotiation that may lead to sub optimisation.

History may also influence the way transfer pricing is used, this was noted by the fact that many sales companies still engage in negotiation of transfer pricing, although it does not produce value to the company. It may take several years for the company to succeed in eliminating this behaviour.

5.2.4 Responsibility and Ideology

The responsibility was earlier identified as of importance to fully understand functions and activities. Brunsson talks of external norms versus efficiency, where internal structures, processes and ideologies are not always compatible with the demands imposed by the institutional environment. This mean that two forms of organisations evolve, one that is the formal organisation which obeys the institutional norms, and that can easily adapt to new fashions or laws. A quite different organisation structure can be used in reality in order to coordinate action. Organisations can also produce double standards or “double talk”; keep separate ideologies for separate needs. The nature of external norms may further be inconsistent in terms of structures, processes and logical, technical or resource-based.¹⁷⁹ As Levey notes, there is much resistance of creating separate sets of records apart from those kept in the ordinary course of business. Segmenting product lines that are not otherwise broken out for business or management purposes, or creating expense allocation keys to accommodate the segmentation, can often create more cost for the MNCs transfer pricing documentation.¹⁸⁰ Some external demands call for centralised organisational response, while others for decentralization. These norms are even more difficult for companies to manage organisational action dependent on consistency. Avoidance of such situations can expose organisations to conflicting demands. One way to avoid this is to focus on consistency between ideology and action.¹⁸¹

5.2.5 Ideology at Alfa Laval

The documentation requirement showed how Alfa Laval Lund was forced to engage in double talk in the lack of existing documents. Which business model to adopt for

¹⁷⁹ Brunsson, (1989), p. 6

¹⁸⁰ Levey, (2001), p. 113

¹⁸¹ Brunsson, (1989), p. 6

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Alfa Laval the authors argue is not merely an issue for decentralised functions. Many group companies and business units are affected. The need for consistency within Alfa Laval may show a need to consider documentation on a more global level. The risk of using resources in one group company may be affected by strategic decisions taken somewhere else in the organisation. This was apparent in addressing the organisational changes in the documentation at Alfa Laval Lund. The discussion outlined by Brunsson shows the importance for the company, as well as tax authority, to coordinate the formal with the informal communication. External demands may be in conflict with the internal ideal choice of action for operational efficiency. Therefore a more global approach is to be recommended. As mentioned early in the report Alfa Laval will continue work with transfer pricing documentation. It is important to ensure gains of the work already made.

It is the opinion of the authors that engaging in too much “double talk” will eventually result in too many resources being used. The documentation must be seen as an excellent opportunity to let the authorities know of operational constraints. To for example show the difficulties with decision making and use of management control systems, the result of the documentation is more accurate. For example the way the star chart differs from the financial results may be caused by sales or pricing dilemmas, market specific factors and annual variations. This may be hard by analyzing in reference to “the way it should work”. The tax authority on the other hand needs to learn more of how companies use double language to cope, as well as understand why.

5.2.6 Educate Tax Authorities

It is important to kill the assumptions of the Swedish tax authorities that documentation work for large corporations is merely a question of gathering documents that already exist in the organisation. One suggestion of doing this is to include a methodology in the documentation and point out the factors determining depth and width of the analysis. Another is to point out the complex ways of responsibility patterns and decision making that in turn lead to ways of measuring performance and reporting in companies. The way Customer Segments dominate this reporting at Alfa Laval affect the transfer pricing outcome and puts the legal entity of Alfa Laval Lund in the shadow. With this discussion it is fair to say that the research of Brunsson is clearly shown in a real example. There is a constant need for corporations to engage in two different languages for internal and external demands. The efficiency of reaching internal goals must be put in context of the way to balance external demands. It is a fair assumption to make that Alfa Laval wants to avoid time consuming and conflict issues with the tax authority.

5.3 Extent and Future of the Transfer Pricing Issue

The findings of chapters 5.1 “*Model Appliance*” and 5.2 “*Discussing Transfer Pricing*” are even more interesting when put in reference to future developments. This discussion may bring value to the studied company as well as those in similar situations, or target groups of transfer pricing documentation.

5.3.1 Developments and Future Implications

In late 2000 Cooper asked the question why transfer pricing was regarded to be as important and why it continued to have an impact on multinationals. His research showed three major reasons. First, new legislation, rulings and practices have made transfer pricing a major compliance burden. Whereas many international companies merely set their transfer prices in the past, now they have to set them, justify them and document them, or run the risk of severe non-compliance penalties. Second, when tax authorities disagree with a MNCs transfer pricing, which has happened frequently, transfer pricing becomes the centre of controversy, which can be time-consuming and expensive to resolve. Third, and perhaps most important, transfer pricing has become central to achieving many international companies' operational objectives and most tax objectives.¹⁸²

Despite the high profile of transfer pricing among tax authorities and tax executives, and the central role it can play in achieving both operational and tax objectives, transfer pricing has not yet been elevated sufficiently to the level of the boardroom or the offices of the key strategic decision-makers within MNCs. Only 30 percent of multinationals consider transfer pricing on a real-time basis, as part of strategic decision-making. For the remainder, transfer pricing seems to be primarily a compliance driven matter.¹⁸³

Stanley argues that this has to change. Companies must be prepared in advance for any requests for documentation that they may receive from revenue authorities. This means considering transfer pricing planning as part of overall business planning. In the past transfer pricing might have been adequately dealt with as just another compliance issue but now you should think of it as part of the planning process. Companies should take it into account in determining the appropriate business model to adopt, in deciding what to prepare and maintain as documentation of that business model and, of course, in setting the resultant transfer prices to ensure that come the day when the tax authorities inevitably say "send us your documentation" the company has it."¹⁸⁴

5.3.2 Frame Analysis

Creed et al claim that organisational demands can benefit from frame analysis. Frame analysis offers an understanding the strategic, regulatory and cultural dimensions of organisational policy.¹⁸⁵ Hoffman and Ventresca (1999) acknowledge how institutional arrangements shape how organisational actors frame, respond to and solve problems. Frames surrounding policy debates allow two kinds of institutional change. One where the dominant interests help reframe new and competing interests, and the other where change efforts attempts to restructure existing framework in order to give rise to new possibilities for action.¹⁸⁶

¹⁸² Cooper, (2000), p. 13

¹⁸³ Ibid

¹⁸⁴ Stanley, (2001), p.25

¹⁸⁵ Hoffman et al, (1999) as referred to in Creed et al., (2002), p. 34 - 37

¹⁸⁶ Creed et al, (2002), p. 37-38

5.3.3 Extent and Future of Issue for Alfa Laval

From the researched literature we can conclude that transfer pricing may come to be a growing issue once again for companies, however in the new form of transfer pricing requirements. If it has already begun to reach the management boardroom of multinationals can not be answered in general by this study, as only one company is included in the study. However a few examples of important determinants to consider are presented in this study. These determinants may help understand at what level and to what extent this phenomenon should be considered. In the case of Alfa Laval the major determinants are strategies that mean changes in legal terms, such as moving businesses from one country to another, or in ways of selling, such as increased sales by commissions.

The earlier arguments of the need for global perspective of transfer pricing issues for Alfa Laval must be put in context of the current and future business situation. The need for transfer pricing documentation for Alfa Laval Lund and Alfa Laval as a whole in the future may change. The work with direct invoicing in the change program documented in step one would mean that the sales companies would move from profit centres to pure cost centres. This would definitely decrease the issue of focusing on transfer pricing within Alfa Laval. At least the extent of the issue is believed not to be as large to attract the interest of top management. Following the use of transfer pricing as a tool for operational or even tax goals would diminish, and with that the interest from tax authorities. The discussion of the various business activities and how they are about to change in legal and operational terms are therefore once again identified as important factors for transfer pricing. How sales may differ in the future is very important for transfer pricing and documentation requirement. This information was as mentioned earlier not sufficiently evident by using the approaches in the framework used.

In using frame analysis the extent to which Alfa Laval will regard transfer pricing in the future can be made even clearer. The already existing frame of operational organisation within Alfa Laval has dominated. Hence the new interests in terms of the documentation requirement are argued to be reshaped by the already existing interests in the organisation. This has shaped the documentation and limited the documentation in terms of format, mode of presentation and key numbers discussed in the steps presented earlier. For example, the reporting of sales and allocation of costs to Customer Segments in Alfa Laval as seen throughout the documentation have been dominant parameters. The study therefore shows that the new regulatory requirements, although the compliance burden, does not reframe operations within Alfa Laval Lund. Given the changes of business unit and their responsibilities discussed earlier, this may however come to change.

5.3.4 Reframing in Progress?

However, with the possibility of Alfa Laval still engaging heavily in transfer pricing, there may be strong implications for how the organisation operates given the documentation requirement. The growing issue noted in surveys may affect how companies such as Alfa Laval may alter their way of reporting, for example in

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financial support systems and cost allocation programs. The study shows that the documentation work would benefit greatly from gathering data in a more efficient way and narrowing down the sources of information. Hence, this development may have important implications for how Alfa Laval can alter their perception of dominant interests in the future. For example, this may be one interest pushing for new ways of cost allocation, such as ABC. It may also outline a need for reviewing strategies for how pricing is dealt with in the company. The avoidance of transfer pricing focus for Alfa Laval is currently a big issue. By integrating the issue in strategic planning the double talk can be managed and internal and external focus of strategies can be combined.

6 Conclusions

6.1 Models and Stakeholders

The two conclusions mentioned in chapter four provide us with important aspects of transfer pricing documentation. The first one, regarding use and appliance of models, provide us with an understanding of how different stakeholders may have interests in these kinds of external demands facing companies. It is therefore important for companies to question the requirements in deciding trade offs between resource use and meeting external requirements. “Reasonable efforts” are argued to be of little help for this purpose.

6.2 The Need for Context

The practical use of the framework has shown difficulties. Therefore the second conclusion addresses how transfer pricing can not be disregarded from organisational and operational demands in a company. This stresses the need to look at the future of transfer pricing documentation requirement. How this can affect a company was elaborated in the chapter 5.3 questioning the extent of the issue. Some concluding remarks from that discussion can be made. By looking at operations in a global point of view a company can decide weather to include transfer pricing in the overall business planning. The relationship is further outlined in the following section.

6.3 Implications for the Future

The overall business planning, or overall strategies, are in this study seen to affect the way the operational and legal business units are structured. This in turn affects the need for transfer pricing in the company, both nationally and internationally. The extent to which transfer pricing is used and how, affects the extent of the interest from tax authorities. The importance of engaging in transfer pricing documentation is determined by this. Last, the importance of transfer pricing documentation may decide to what degree it is considered in the overall business planning in the company.

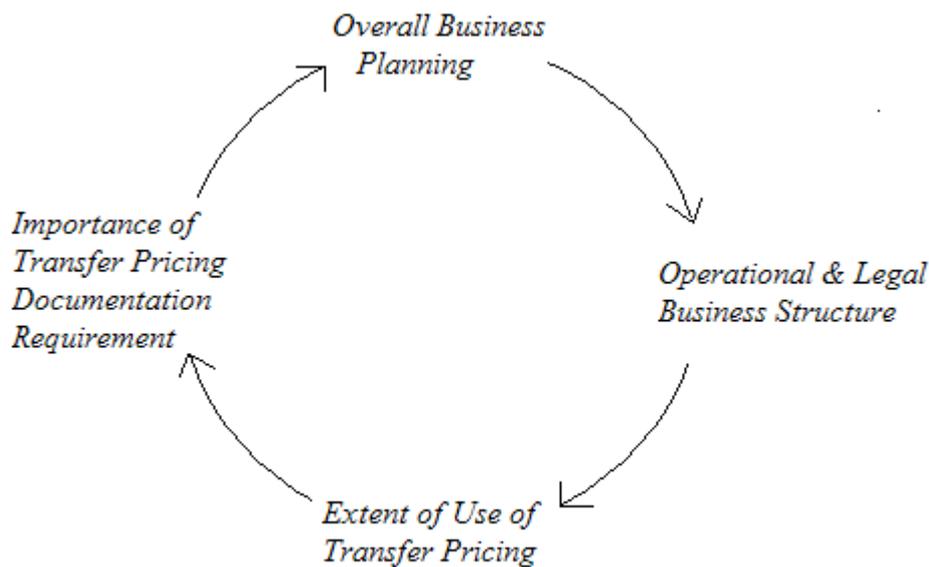


Figure 13: Model showing Cyclic Relationship of Transfer Pricing Affect

It is important to note that the OECD is not the tool designer, but merely the director of the development. Judging by the researched literature the OECD is well aware of the problems of defining the choice of transfer pricing methods in companies; however it has not yet achieved satisfying means of how to address these problems. The study shows that companies may struggle by the gaps in the guidelines for documenting transfer pricing. By looking at the development so far the OECD may soon follow the US, and recommend tax authorities to regulate towards more document-specific approaches. Noting that the OECD wants to stay flexible, and the increase of the profit methods in companies may put pressure on the OECD. This may suggest that the OECD have to realise the dilemmas of the company perspective and accept these methods than regard them as means of a last resort. In a way it can be argued that it is the responsibility of the companies to push this development and

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point this out to the target groups of documentation. Many of the findings in this report may be used as arguments for requesting more specific approaches.

6.4 Limitations of the Conclusions

This study has been performed in very practical terms and only one framework and one company has been considered. The practical use of the framework must be considered in regards to the circumstances of the specific case. Thus, chapter 4.7.1 “*What Affected the Outcome?*” is highly relevant for the conclusions of this study. Examples and suggestions of framework should not be seen in absolute terms. Keeping this in mind, the authors argue that the lessons learned from this study may be valuable for Alfa Laval Lund as well as others.

To explore who may benefit from this study we can conclude that the global concern of Alfa Laval is in the process of dealing with transfer pricing documentation. The organisation may therefore have valuable information by this study. For whom else these lessons can assist may only be a matter of speculation. The tax authority might gain further knowledge of the dilemmas for companies facing this requirement. Other companies of similar size, industry or organisation may benefit from examples used and dilemmas addressed. However the circumstances of the specific case must once again be stressed as a major influence of the suggestions made.

6.5 Suggestions for Further Research

The comparability aspect has been visible as an important criterion in many sources used. However this study lacks the possibility of reviewing the implications and results of including comparability in the practical use of transfer pricing frameworks. This is suggested for further research.

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8 Appendices

8.1 Appendix A: Figures

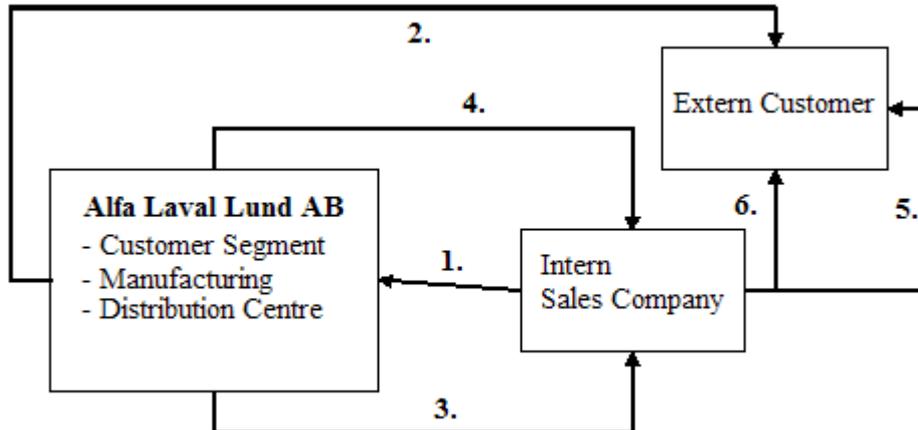


Table 1, General flow of goods, payment and legal entity at Alfa Laval Lund

Step1: An order are placed by the local sales company which have confirmed a deal with the extern customer. Operations at Alfa Laval Lund receive the order from the local sales company.

Step2: Alfa Laval Lund ships the requested goods directly to the extern customer.

Step3: The invoice of the products alarm price is sent from Alfa Laval Lund to the sales company who pays to Alfa Laval Lund.

Step4: Legal title passes from Alfa Laval Lund to the sales company when the sales company pays the invoice.

Step5: The sales company invoice the extern customer for the products market price.

Step6: Legal title passes from the sales company to the end customer when the extern customer pays the invoice.

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8.2 Appendix B: Tables

Transactions			Involved entities			
<i>Type</i>	<i>Description</i>	<i>Related annual turnover</i>	<i>Name of domestic entity</i>	<i>Domestic entity role</i>	<i>Name of foreign entity</i>	<i>Foreign entity role</i>
Tangible goods	Heat exchanger	50 MSEK	CompanyA	Manufacturer	Company B	Distributor
Services	IT-consulting	6 MSEK	CompanyC	Head Office	Company B	Distributor
Services	Market campaign	1 MKR	CompanyC	Manufacturer	Company B	Distributor

Table 2, Example of the outlining of the Intra Group Transaction List

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	Total			Internal Sales			External Sales		
Entity	Gross Margin	Gross Profit	%	Gross Margin	Gross Profit	%	Gross Profit	Gross Margin	%
Kenya	56,59%	53705	0,05%	0,00%	0	0,00%	53 705	56,59%	0,42%
South Africa	29,79%	2597108	2,50%	29,79%	2597108	2,85%	0	0,00%	0,00%
Belize	63,45%	123686	0,12%	0,00%	0	0,00%	123 686	63,45%	0,97%
Canada	49,19%	60276	0,06%	49,19%	60276	0,07%	0	0,00%	0,00%
Dominican Rep	48,01%	28078	0,03%	0,00%	0	0,00%	28 078	48,01%	0,22%
United States	23,97%	96790	0,09%	23,00%	73571	0,08%	23 219	27,68%	0,18%
Argentina	41,12%	21910	0,02%	39,83%	20499	0,02%	1 411	77,38%	0,01%
Brazil	9,15%	254777	0,24%	9,15%	254777	0,28%	0	0,00%	0,00%
Chile	47,78%	46847	0,05%	56,08%	32714	0,04%	14 133	35,58%	0,11%
Colombia	13,96%	5118	0,00%	13,96%	5118	0,01%	0	0,00%	0,00%
Ecuador	45,61%	91443	0,09%	0,00%	0	0,00%	91 443	45,61%	0,72%
Peru	47,40%	197468	0,19%	44,95%	140187	0,15%	57 280	54,70%	0,45%
China	8,92%	535153	0,51%	8,92%	535153	0,59%	0	0,00%	0,00%
Taiwan	22,56%	126577	0,12%	21,65%	35637	0,04%	90 940	22,94%	0,71%
India	20,46%	154915	0,15%	16,18%	110527	0,12%	44 388	59,85%	0,35%
Indonesia	54,92%	25879	0,02%	0,00%	0	0,00%	25 879	54,92%	0,20%
Israel	55,54%	61818	0,06%	0,00%	0	0,00%	61 818	55,54%	0,49%
Japan	56,50%	3135166	3,01%	56,50%	3135166	3,44%	0	0,00%	0,00%
Kazakhstan	54,53%	26821	0,03%	0,00%	0	0,00%	26 821	54,53%	0,21%
Korea (South)	32,03%	2137215	2,05%	35,78%	1575889	1,73%	561 326	24,74%	4,41%
Malaysia	33,87%	189000	0,18%	33,87%	189000	0,21%	0	0,00%	0,00%
Philippines	29,89%	8206	0,01%	29,89%	8206	0,01%	0	0,00%	0,00%
Singapore	18,17%	583416	0,56%	18,17%	583416	0,64%	0	0,00%	0,00%
Thailand	19,68%	413679	0,40%	14,88%	292761	0,32%	120 918	90,06%	0,95%
Un Arab Emir	3,93%	458294	0,44%	3,93%	458294	0,50%	0	0,00%	0,00%
Austria	12,73%	1474049	1,42%	12,73%	1474049	1,62%	0	0,00%	0,00%
Belgium	16,14%	934898	0,90%	16,14%	934898	1,02%	0	0,00%	0,00%
Boznia	56,26%	39622	0,04%	0,00%	0	0,00%	39 622	56,26%	0,31%
Bulgaria	5,01%	57148	0,05%	5,01%	57148	0,06%	0	0,00%	0,00%
Slovak Rep	26,07%	355659	0,34%	26,07%	355659	0,39%	0	0,00%	0,00%
Czech Rep	31,24%	2559356	2,46%	31,24%	2559356	2,80%	0	0,00%	0,00%
Denmark	28,27%	9142399	8,79%	38,85%	1440941	1,58%	7 701 459	26,89%	60,47%
Finland	32,23%	2886448	2,78%	32,23%	2886448	3,16%	0	0,00%	0,00%
France	23,00%	3601178	3,46%	23,00%	3601178	3,95%	0	0,00%	0,00%
Germany	29,42%	19687004	18,93%	29,40%	19645245	21,52%	41 760	40,97%	0,33%
Greece	34,66%	346624	0,33%	34,66%	346624	0,38%	0	0,00%	0,00%
Hungary	31,32%	2314741	2,23%	31,32%	2314741	2,54%	0	0,00%	0,00%
Iceland	44,60%	674246	0,65%	0,00%	0	0,00%	674 246	44,60%	5,29%

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Italy	25,79%	9828953	9,45%	25,79%	9828953	10,77%	0	0,00%	0,00%
Luxembourg	35,14%	16226	0,02%	35,14%	16226	0,02%	0	0,00%	0,00%
Netherlands	27,00%	3555741	3,42%	26,62%	2554566	2,80%	1 001 175	28,03%	7,86%
Norway	32,01%	1885055	1,81%	31,93%	1877285	2,06%	7 770	81,00%	0,06%
Poland	29,47%	3565881	3,43%	29,47%	3565881	3,91%	0	0,00%	0,00%
Portugal	17,54%	549308	0,53%	17,54%	549308	0,60%	0	0,00%	0,00%
Romania	7,67%	250411	0,24%	7,67%	250411	0,27%	0	0,00%	0,00%
Spain	23,67%	5985728	5,76%	23,67%	5985728	6,56%	0	0,00%	0,00%
Sweden	21,57%	6873923	6,61%	23,40%	6669099	7,31%	204 823	6,09%	1,61%
Switzerland	18,56%	950775	0,91%	18,56%	950775	1,04%	0	0,00%	0,00%
Turkey	25,91%	3038318	2,92%	25,40%	2906769	3,18%	131 549	46,79%	1,03%
UK	27,98%	2694765	2,59%	26,85%	2374843	2,60%	319 922	40,81%	2,51%
Russia	33,69%	1734575	1,67%	33,69%	1734575	1,90%	0	0,00%	0,00%
Estonia	34,78%	227097	0,22%	34,78%	227097	0,25%	0	0,00%	0,00%
Latvia	30,50%	2156557	2,07%	30,61%	2129477	2,33%	27 080	23,87%	0,21%
Lithuania	20,44%	482269	0,46%	20,44%	482269	0,53%	0	0,00%	0,00%
Ukraine	52,72%	1105038	1,06%	0,00%	0	0,00%	1 105 038	52,72%	8,68%
Australia	31,01%	1736183	1,67%	31,01%	1736183	1,90%	0	0,00%	0,00%
New Zealand	35,50%	1862262	1,79%	33,81%	1706656	1,87%	155 606	78,50%	1,22%
Total		104005777	100,00%		91270685	100,00%	12 735 092		100,00%

Table 2, Key figure analysis for ECR. All figures is changed by X%

		Total			Internal Sales			External Sales		
Entity	Gross Profit	Gross Margin	%	Gross Profit	Gross Margin	%	Gross Profit	Gross Margin	%	
South Africa	95 932	16,06%	0,21%	95 932	16,06%	0,26%	0	0,00%	0,00%	
Canada	514	0,08%	0,00%	514	0,08%	0,00%	0	0,00%	0,00%	
Mexico	-9 277	-4,96%	-0,02%	-9 277	-4,96%	-0,03%	0	0,00%	0,00%	
United States	817 013	13,08%	1,80%	817 013	13,08%	2,21%	0	0,00%	0,00%	
Argentina	85 720	22,48%	0,19%	85 720	22,48%	0,23%	0	0,00%	0,00%	
Brazil	431 320	10,34%	0,95%	431 320	10,34%	1,17%	0	0,00%	0,00%	
Chile	1 255 700	23,12%	2,77%	263 371	35,20%	0,71%	992 329	21,19%	11,89%	
Colombia	480 549	42,65%	1,06%	0	0,00%	0,00%	480 549	42,65%	5,76%	
Peru	81 355	39,60%	0,18%	54 621	32,97%	0,15%	26 734	67,20%	0,32%	
Venezuela	86 200	63,76%	0,19%	0	0,00%	0,00%	86 200	63,76%	1,03%	
China	3 312 677	18,72%	7,31%	3 312 677	18,72%	8,96%	0	0,00%	0,00%	
Taiwan	152 279	19,47%	0,34%	45 029	29,95%	0,12%	107 249	16,98%	1,29%	
Cyprus	151 467	31,46%	0,33%	0	0,00%	0,00%	151 467	31,46%	1,82%	
India	233 464	13,62%	0,52%	228 444	15,30%	0,62%	5 019	2,27%	0,06%	

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Indonesia	394 707	38,58%	0,87%	135 910	28,35%	0,37%	258 797	47,60%	3,10%
Israel	133 932	51,80%	0,30%	0	0,00%	0,00%	133 932	51,80%	1,61%
Japan	505 885	9,95%	1,12%	505 885	9,95%	1,37%	0	0,00%	0,00%
Kazakhstan	649 783	47,89%	1,43%	0	0,00%	0,00%	649 783	47,89%	7,79%
Korea (South)	921 819	26,09%	2,03%	381 978	24,64%	1,03%	539 841	27,22%	6,47%
Malaysia	98 908	28,05%	0,22%	98 908	28,05%	0,27%	0	0,00%	0,00%
Philippines	996 653	46,37%	2,20%	43 282	26,45%	0,12%	953 370	48,01%	11,43%
Singapore	138 554	31,65%	0,31%	138 554	31,65%	0,37%	0	0,00%	0,00%
Thailand	201 135	6,20%	0,44%	102 944	26,23%	0,28%	98 191	3,44%	1,18%
Un Arab Emir	1 038 469	18,30%	2,29%	1 038 469	18,30%	2,81%	0	0,00%	0,00%
Uzbekistan	1 288 001	47,62%	2,84%	0	0,00%	0,00%	1 288 001	47,62%	15,44%
Austria	272 852	5,73%	0,60%	272 852	5,73%	0,74%	0	0,00%	0,00%
Belgium	3 961 484	20,14%	8,74%	3 961 484	20,14%	10,72%	0	0,00%	0,00%
Bulgaria	331 085	35,26%	0,73%	331 085	35,26%	0,90%	0	0,00%	0,00%
Slovak Rep	151 563	87,94%	0,33%	151 563	87,94%	0,41%	0	0,00%	0,00%
Czech Rep	93 710	10,00%	0,21%	93 710	10,00%	0,25%	0	0,00%	0,00%
Denmark	1 681 101	26,67%	3,71%	1 667 126	26,77%	4,51%	13 975	18,48%	0,17%
Finland	1 101 524	22,10%	2,43%	1 101 524	22,10%	2,98%	0	0,00%	0,00%
France	2 453 049	23,52%	5,41%	2 453 049	23,52%	6,64%	0	0,00%	0,00%
Germany	5 319 411	16,43%	11,74%	5 319 300	16,44%	14,39%	110	0,81%	0,00%
Greece	38 001	50,16%	0,08%	38 001	50,16%	0,10%	0	0,00%	0,00%
Hungary	145 787	15,04%	0,32%	145 787	15,04%	0,39%	0	0,00%	0,00%
Italy	2 632 098	12,04%	5,81%	2 632 098	12,04%	7,12%	0	0,00%	0,00%
Netherlands	1 924 346	22,72%	4,25%	1 924 346	22,72%	5,21%	0	0,00%	0,00%
Norway	469 952	26,85%	1,04%	469 952	26,85%	1,27%	0	0,00%	0,00%
Poland	451 390	23,05%	1,00%	451 390	23,05%	1,22%	0	0,00%	0,00%
Portugal	122 056	24,58%	0,27%	122 056	24,58%	0,33%	0	0,00%	0,00%
Romania	310 639	30,85%	0,69%	310 639	30,85%	0,84%	0	0,00%	0,00%
Spain	2 083 064	24,82%	4,60%	2 083 064	24,82%	5,64%	0	0,00%	0,00%
Sweden	1 838 708	27,93%	4,06%	1 843 938	28,26%	4,99%	-5 230	-9,06%	-0,06%
Switzerland	955 114	18,82%	2,11%	955 114	18,82%	2,58%	0	0,00%	0,00%
Turkey	901 684	14,34%	1,99%	83 455	4,02%	0,23%	818 229	19,44%	9,81%
UK	1 829 033	28,27%	4,04%	1 829 033	28,27%	4,95%	0	0,00%	0,00%
Russia	217 758	5,86%	0,48%	217 758	5,86%	0,59%	0	0,00%	0,00%
Latvia	39 784	32,55%	0,09%	39 784	32,55%	0,11%	0	0,00%	0,00%
Lithuania	85 827	22,46%	0,19%	85 827	22,46%	0,23%	0	0,00%	0,00%
Ukraine	1 745 019	45,75%	3,85%	0	0,00%	0,00%	1 745 019	45,75%	20,91%
Australia	339 168	16,38%	0,75%	339 168	16,38%	0,92%	0	0,00%	0,00%
New Zealand	269 591	60,09%	0,60%	269 591	60,09%	0,73%	0	0,00%	0,00%
Total	45 307 558		100,00%	36 963 989		100,00%	8 343 568		100,00%

Table 3, Key figure analysis for PPI. All figures is changed by X%.

The Key Figure Analysis, which is represented in table 2 and 3 is a comparison of Gross Profit and Gross Margin at group and extern sales between the countries sold to are performed in purpose of show the profit and margins for the specific countries. It displays the Invoice value, Gross Profit, Gross Margin and the percentage of the total Gross Profit for each country.¹⁸⁷

8.3 Appendix C: Interview Form

(All questions are followed by)

Involved entities: Alfa Laval Lund AB
Foreign country

1. Strategy development ant strategic control

What are the success factors determining and influencing Alfa Laval Lund AB's position in the marketplace?

Who managers the impact of those success factors?

Who designs the overall corporate strategy (structure and operating procedures)?

Is there upward feedback or input concerning the overall strategy?

Who tracks and describes the influence of competitors in the market?

Who decides on the reactions of such results?

2. Corporate reputation

How significant are the above-mentioned trademarks, trade names and/or patents to your business?

Who advises or instructs in the formulation and implementation of advertising programmes, product information and public relations?

4. Legal and regulatory affairs

Who is responsible for legal matters?

Who pays for and arranges product liability or other insurance?

Who tracks regulatory developments and communicates these through the organisation?

¹⁸⁷ Internal operating report, Alfa Laval Lund AB, p. 24

Are lobbying activities undertaken?

Is the company a member of a trade organisation?

What decisions require head office approval, and what approvals are required?

6. Human resource management

Is any management training undertaken? If yes, who develops the manuals and programmes?

Who is responsible for the employment of staff?

If any, who designs bonus or incentive programmes for executives and/or staff?

Are there any expatriates (overseas workers) between overseas affiliates? If yes, what positions do they hold in the company?

7. Administration

Who administers the day-to day operations of the headquarters or main office?

Is this functions outsourced?

Is the function under development?

1. Product management

What products are produced for the foreign country? Please provide a description of the different product lines.

Who is responsible for deciding which products to produce?

Who designed the products, and who owns the technology?

2. Research and Development

What R&D activities are carried on?

If any, what research is carried out on your behalf by related parties?

If any, what research is carried out on your behalf by third parties?

Where are products designed?

How important is the development of patents in the industry?

If any, what patented processes, products, etc. And trademarks/trade names are owned by group companies?

If any, what licences and technical assistance agreements have been made with related/unrelated parties?

If any, what patents do you own that create unique products which competitors cannot duplicate?

Does the company have any unpatented technical know-how which might differentiate your services, enhance cost efficiency or increase your market share?

What decisions require head office approval, and what approvals are required?

Who formulates the R&D budget?

Do you have licence agreement with related/unrelated parties?

Is there a cost-sharing agreement in force? In the affirmative, what are the details thereof?

3. Manufacturing process design and know-how

What is in summary the degree of standardisation for products sold in the country in question?

Who developed the original process, and have any improvements been made locally?

4. Purchasing

What materials, finished goods, etc. Are purchased?

From whom are purchases made?

Are any purchases made from related parties? In the affirmative, how are prices determined?

Who performs the purchasing function, plans purchasing schedules, negotiates purchasing arrangements, and approval the vendor as having acceptable qualifications?

5. Inbound logistics

Who pays freight charges on internal trade, and what are the terms?

Who arranges shipping, and who is responsible for the selection of shippers?

Who is responsible for inbound shipping deadlines?

6. Outbound Logistics

Who pays freight charges for outgoing product?

What are the standard terms?

Who arranges shipping of outbound products?

Who is responsible for meeting outbound shipping deadlines?

7. Productive equipment

Who has expenditure authority for capital equipment?

From whom is productive equipment purchased?

What corporate approvals are required?

Are any purchases made from related parties? In the affirmative, how are prices determined?

8. Product fabrication and assembly

How are the company's goods manufactured in summary (mass production, flexible production, assembly)?

Who performs the production functions?

Is the company involved with contract manufacturers or assemblers?

Are any related parties contract manufacturers or assemblers?

9. Packaging and labelling

What packaging and labelling is done and where?

Who makes the decisions in relation to packaging and labelling?

What input do other functional areas (i.e. legal and regulatory affairs or marketing) have on packaging and labelling?

10. Production scheduling

Who schedules production?

Is a production scheduling programme employed? In the affirmative, who develop it?

Who influences the production schedule?

Who determines the product mix to be manufactured during a certain period?

11. Stock

Where is stock held and who owns it?

Who controls the levels of stock and how is the stock level controlled?

How many days of stock are on hand?

12. Quality Control

What general quality control measures do your company take?

Who sets the quality control standards and bears the cost?

Who performs the quality control and bears the cost?

Who provides the equipment and techniques for quality control checks?

How many products are lost because they fail to pass quality control checks?

13. Cost control

Who is responsible for cost control and vendor relations?

How are costs managed?

What internal cost control measures are implemented?

1. Marketing, Strategy and Development

Who performs the marketing function?

Who formulates the marketing budget?

Do related parties carry out marketing activities on your behalf?

Are market surveys performed?

Which entities monitor the market demand?

Who assesses the demand in foreign markets?

What are the risks related to the demand for your products?

2. Sales and pricing

Who sells the product?

How are the external sales prices determined? Which is more important in determining the price structure: Product margin or sales volume?

Does your company have an official price list? Can prices be tactically changed to meet specific customer demands? If yes, what approvals are required?

Who formulates the projections and sets targets, and who is responsible for the achievement of sales targets?

Who negotiates sales contracts, and do such persons operate autonomously?

3 Tactical marketing and advertising

Determine the extent of marketing /advertising activities the company carry out?

Who pays for marketing and advertising activities?

Are trade shows being used? If yes, who organises them and who pays for them?

Who is responsible for producing product brochures, specifications sheets etc., and who pays for it?

4. Order processing

Where are sales orders received?

Who issues the invoices to customers?

Who issues the invoice to related parties?

Who tracks the fulfilment of an order?

Whom may the customer contact to determine the status of an order?

5 Distribution on networks

How is the product distributed?

Have any potential customer lists been obtained through acquisition?

Who manages the network?

6. Installation and after-sales service

Do you install your products?

Do you provide after-sales service? If yes, please describe such services in summary.

Who bears the cost of installation and after-sales service?

7. Market risk

What are the market risks, and how significant are they (if possible, please give some illustrative examples)?

Is the market volatile or stable?

Which entity bears market risks?

Do competitors bear the same risks?

8. Product liability risk

What precautions are taken to protect the company from product liability risk?

How significant are such risks?

Who estimates the cushion for product liability risk, and what approvals are required?