

## MAXIMIZING PROFITS PROCUREMENT'S NEW ROLE?

*It may seem like an unlikely combination – procurement and profits – but the title is correct. Procurement can play an important role in maximizing your profits. But how? Well, it's all about taxation and definitions in the supply chain. What is a part? What is a product? How does a component change from part to product? Get these definitions right, set up the appropriate infrastructure, and your procurement organization will be able to create and exercise options that significantly reduce your taxes.*

Taxation can be viewed as a service procured from governments. To procure taxation effectively, it is important to involve the procurement organization early. Taxation is similar to other procured services – the rates are negotiable and its overall cost depends on when the procurement organization is involved in designing products and in defining the supply chain strategy. Procurement organizations can greatly enhance the effectiveness of tax planners through some common techniques to reduce tax rates such as tax shifting and an exciting new method: tax options. However, to take advantage of this new option, you need to set up a particular buy-sell infrastructure. This is described below.

### Take yoghurt

First, however, to explain this new technique, we will focus on the smallest element of every product, the component. Sometimes a component sold between organizations is a product

with a list price established by the market. At other times, it is an identical component sold between entities as a part used to assemble a product. Let's take a simple product as an example: the yoghurt SKU. The yoghurt itself is a component. The cup and lid are products in their own right but are used as parts in assembling the yoghurt SKU. Once filled, the cup with yoghurt inside is less valuable as it cannot be used for anything else. The cup, as a part incorporated in the final product, is less valuable than an empty cup. In other words, the yoghurt assembly process increases the value of some components (the yoghurt) and destroys the value of others (the cup). If this value destruction is accounted for properly in your taxation system, procurement programs will be able to lower your tax bills. At IQ (name changed), a multinational and major player in the electronics industry, this sort of initiative cut tax rates nearly in half.

Most accounting standards consider this part vs. product situation by treating parts and products differently. Specifically, most parts are transferred at a cost-plus price (cost plus a markup percentage), and most products are transferred at a list-less price (list price minus a discount percentage). Usually, the product design and supply chain configuration are taken as given, and the management task is simply to follow accounting standards. This acceptance of part and product definitions and the supply chain configuration may cause a company to significantly overpay their taxes.



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### Part-product ambiguity

Many components can be either a part or a product, depending on the context that the firm creates. This context is created by the product design, how it is assembled and procured. We call this "part-product ambiguity" and components with this ambiguity "part-products". This is the basis of tax options created by procurement organizations.

The traditional view of assembly is that it takes components or ingredients of a certain value, and aggregates them into a form that has a higher total value. Certainly, assembly must increase the total value of the set of components to be sustainable in the long term. But the way in which this added value is tied back to individual components depends on the context. Typically, all components used in assembly are treated as parts, whose value is increased after assembly. The total profit margin is simply allocated proportionally across all components through some form of cost-plus transfer pricing. This is administratively convenient but may result in significantly higher taxes being paid than selectively treating part-products as products rather than parts.

Different components contribute differently to the final product's value creation. For some components, being assembled into an end product may even destroy some of their economic value, although this may be necessary for creating net total value. The true economic value for a component can be inferred from its alternative uses. Generally, any action like localization that reduces a component's alternative use reduces that component's economic value. As explained earlier with the yoghurt cup, assembling a standard component that has many alternative uses into a finished product destroys the economic value of the standard component. Standard components with many alternative uses also often have a standard interface (like a computer memory chip that uses a common plug for computers across all brands).

Part-product ambiguity arises when a particular component can be sold on the open market as its own finished product, such as an accessory

to the complete assembled product, or used in a different end product. Typically, components with standard interfaces are part-products.

For example, assembling a standard memory module for a notebook computer reduces its value because to use the module in a different application requires an investment of time and money to remove the module from the computer. Therefore, the assembly process for the memory component destroys value for the component and adds value to the computer.

In an assembled finished product, the overall value comes disproportionately from custom components. That is, a firm makes money on custom components that have limited alternative uses and loses money on part-products. However, these part-products facilitate making a profit on custom components. Besides component design considerations of cost and functionality, a decision to use a standard component rather than a custom component has positive tax consequences when properly exercised. Organizations need to determine if this tax reduction is material and, if it is, procurement should be chartered to harvest the opportunity.

### Who owns what?

A component may pass through several entities along the supply chain, either a division of the parent organization, or outside parties. Determining each organization's taxes requires establishing a cost basis and transfer price for all components at each part of the supply chain. If the material changes title in a purchase transaction between independent organizations, transfer price calculations are relatively easy. However, if ownership doesn't change or the entities are part of the same parent organization, it requires some sort of transfer pricing scheme to provide legal and correct financial grounds for computing taxes based on the component transfer prices. This is certainly required to make it possible to specify the sovereignties in which profits will be realized formally. Component transfer prices cannot be made up arbitrarily. They must be defensible and consistent with the accepted accounting standards and tax laws of all countries involved.

Legally, a product can be transferred between divisions at a transfer price of “list-less”. A market price exists and transfer price is often just a deduction of some percentage off the market price. This is often true for high-margin product accessories: the skin of a cell phone, the memory module for a PC, the battery of a car or a yoghurt cup. If list-less transfer pricing is used when a supplier sells its output to the product factory, the product factory may show reduced profit on the final product because of a higher transfer price on this component. Of course, the component factory or procurement department has higher profits, which can be taxed at a lower rate than the product factory.

For high-margin accessories, the list-less price is typically greater than the commonly used “cost-plus” transfer pricing used for parts. The transfer pricing difference between these methods can be viewed as a tax option. Determining an appropriate transfer price, creating a procurement buy-sell infrastructure and designing a component interface can be considered the cost of the tax option. Correctly accounting for the value-destroying nature of assembling a standard component into an end product can have enormous profit consequences.

### What you need to set up: the buy-sell model

To take advantage of this opportunity you will need to create the necessary infrastructure. To have an option function, there has to be an intermediary (i.e. broker) between the buyer and the seller. Similarly, tax options need an intermediary between the seller of the component (supplier) and the buyer (assembly factory). Experience suggests that the procurement organization, empowered with a buy-sell infrastructure, is ideal for this role.

When adopting a buy-sell strategy, the parent organization creates a global procurement service organization as a legal entity to administer the component buy-sell processes. This organization should be in a low-tax jurisdiction and charge an appropriate commission for its services.

Next, the procurement organization buys components from suppliers at a negotiated unit

cost. It then defines the most advantageous transfer price (list-less or cost-plus) and sells the components to the assembler. Once the assembler has produced the final product, it is sold back to the parent organization at a price that includes the assembler's margin and the value loss of the component due to assembly.

Here, profit outcomes are straightforward and linked directly to the transfer price. When the procurement organization is in a lower tax jurisdiction than the parent organization, the higher the value of the component transfer price, the greater the profit realized in a low-tax jurisdiction and the taxes for the enterprise as a whole are reduced.

### Tax options

There are several requirements if you are to create a tax option using part-product ambiguity.

Firstly, there has to be a market for the part-product component. If the procurement services organization wants to sell a part-product component as a product, it should sell the component to an arms-length channel or consumer customers as well as the assembly factory. For example, the procurement services organization could sell memory modules to end consumers via the web establishing an arms-length price.

There also needs to be positive tax differences between the parent organization country tax rate and the procurement organization country tax rate.

R&D and procurement have to cooperate. If procurement wants to sell a part-product as a part, the component should be designed with minimal alternative uses. Conversely, if procurement wants to sell the part-product component as a product, the product and component should be designed with standard interfaces so that the modules are not “hard-wired” to the final product. Hard-wired parts rarely have part-product ambiguity. The R&D organization needs to ensure that the module can be re-sold separately on the open market to arms-length customers.

**Determining an appropriate transfer price, creating a procurement buy-sell infrastructure, and designing a component interface can be considered the cost of the tax option.**

## Managerial implications

There are several implications for management in setting up this system.

- The higher the difference between the cost of a component and its list price (margin), the more value there is in the component's tax option. Research shows that tax option opportunities are affected significantly by the margin of the component.
- The list-less transfer-pricing factor (discount level from list price) is more important than the cost-plus factor. The lower the list-less factor, the higher the profit procurement can generate.
- Buy-sell infrastructures cost money. You will therefore need a large enough flow of goods to cover the cost of the infrastructure. Alternatively, the parent organization can procure services from external procurement service providers.

- Setting up a tax option strategy requires robust planning and consultation with tax experts. Tax experts should support procurement to ensure the strategy is clearly within legal and reporting boundaries.
- Since accounting standards change frequently, and tax systems are not completely rational, the structure and strategy of the tax options program should be flexible enough to account for those changes. The system of tax options is changing and adapting continually. Some options will become obsolete and others will be created.

*Procurement organizations are in a strategic position to enable tax option strategies. We even argue that without their involvement, a firm will have difficulty implementing tax options resulting in higher overall tax rates. It is up to the procurement executive to take the lead and implement this exciting new model.*

IMD is ranked first in executive education outside the US and second worldwide [*Financial Times*, 2009]. IMD's MBA is ranked number one worldwide [*The Economist*, 2008].

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