Practical Value Chain Analysis—
Designing, Defending and Documenting Your TP Policy

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Objectives

Share practical experience with respect to the use and implementation of Value Chain Analyses in the Transfer Pricing context, notably through case studies
Contents

I. Context

II. Methodological Insights

III. Case Studies

– Pricing of Services
  • Case Study #1: Value Chain-Based Determination of TP system

– Pricing of Products
  • Case Study #2: Value Chain-Based Redesign

– Provision of Capital
  • Case Study #3: An Example of a Value Chain Analysis in Financial Services

– Entities’ Remuneration
  • Case Study #4: Value Chain for a Small Company
I. Context

A. Risks and Transfer Pricing—What does the BEPS Outcome Tell us?
Steps to Delineate Risks
Revised Chapter I of the OECD Guidelines

In its Transfer Pricing Guidelines, the OECD introduces a six-step process to analysing risks

1. Identify economically significant risks in the relevant relational context

2. Determine how risks are contractually assumed

3. Determine which enterprise(s)
   - Perform(s) control functions and risk mitigation functions,
   - Encounter(s) upside or downside consequences of risk outcomes, and
   - Have(s) the financial capacity to assume the risks
Steps to Delineate Risks
Revised Chapter I of the OECD Guidelines

4. Determine whether the contractual assumption of risks is consistent with the *conduct* of the parties by analysing whether
   - The associated enterprises follow the contractual terms; and
   - The party assuming risk exercises *control over the risk* and has the financial capacity to assume the risk

5. Where the party assuming risk does not control the risk or does not have the financial capacity to assume the risk, allocate risk to the entity exercising the control and having the financial capacity to assume the risk
   - In case of multiple entities that both exercise control and have the financial capacity, allocate risk to the entity(ies) having the most control

6. Price the transaction taking into account the financial and other consequences of risk assumption
I. Context

B. Intangibles and Transfer Pricing—What does the BEPS Outcome Tell us?
Steps to Analyze Intangibles Under Revised Chapter VI of the OECD Guidelines

Chapter VI compliant analysis with respect to intangibles:

1. Identification of intangibles

2. Identification of Functions, Funding and Risks relating to intangibles
Steps to Analyze Intangibles Under Revised Chapter VI of the OECD Guidelines

**Definition of an intangible:**
- Is not a physical asset or a financial asset,
- Is capable of being owned or controlled for use in commercial activities, and
- Whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances

**NOT intangibles**
- Group synergies
- Market-specific characteristics (e.g., location savings, consumer purchasing power)
- Assembled workforce

- Patents
- Know-how and trade secrets
- Trademarks, trade names and brands
- Rights under contracts and government licenses
- License and similar limited rights in intangibles

Other: Goodwill and ongoing concern

Source: OECD / G20 BEPS—Guidance on Transfer Pricing Aspects of Intangibles—Action 8: 2015 Deliverables
Steps to Analyze Intangibles Under Revised Chapter VI of the OECD Guidelines

1. **Ownership**

   - Ownership

2. **Functions** *(perform/control)*
   - Development
   - Enhancement
   - Maintenance
   - Protection
   - Exploitation

   **Funding** *(provide)*
   **Risks** *(control/bear)*

**Source:** OECD / G20 BEPS—Guidance on Transfer Pricing Aspects of Intangibles—Action 8: 2015 Deliverables
Steps to Analyze Intangibles Under Revised Chapter VI of the OECD Guidelines

The table below identifies companies within the MNE which perform and exercise control over DEMPE; provide the necessary funding and other assets; and bear and control the various risks associated with the intangible.

<table>
<thead>
<tr>
<th>Intangible XYZ</th>
<th>Functions (perform/control) “important functions”</th>
<th>Funding (provide)</th>
<th>Risks (control/bear)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Perform</td>
<td>Control</td>
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<td>Development</td>
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<td>Enhancement</td>
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<td>Maintenance</td>
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<td>Exploitation</td>
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</table>

Source: OECD / G20 BEPS—Guidance on Transfer Pricing Aspects of Intangibles—Action 8: 2015 Deliverables
“BEPS Impact” on Guidelines

- BEPS has lifted the analytical focus in transfer pricing from transactions to the context of commercial and financial relations.

- Therefore, a more complete and realistic approach to risk is imperative—with direct consequences for the identification of intangibles, ownership thereof and entitlement thereto.

- Post-BEPS, the company-wide transparency on functions, assets and risks can only make sense and be managed on the basis of an understanding of what drives value in the enterprise, i.e., of a value chain analysis.
II. Methodological Insights
Relational Arm’s Length Transfer Pricing

Historically, compliance with the arm’s-length principle is transaction-based. Over time, entity-based outcome comparisons have been introduced as the primary testing method.

The arm’s-length principle itself, however, refers to commercial and financial relations.

Relational Arm’s Length Transfer Pricing defines arm’s length transfer prices that are consistent with both tax and business objectives. The focus is shifted from testing stand-alone entities (the “tested parties”) to mapping the relative position of group entities involved in the process of jointly creating value.
Analytical Framework
Value Creation, Functional Analysis and Roles and Responsibilities

The analytical process described hereinafter aims at understanding:

- How value is being created in the enterprise,
- How individual parties/entities take part in the joint process of creating value,
- What their respective contributions are, and
- How each if them operates and carries responsibility for the relevant types of risk

Ultimately, those elements drive the entitlement to (parts of the) profits of the individual entities

The way in which they carry part of the risks in the enterprise decides not only on the level of suitable remuneration, but also its dynamics

Note:
* This section of the presentation is inspired by the article "Understanding Risk in the Enterprise: The Key to Transfer Pricing for Today’s Business Models," by Pim Fris, Sébastien Gonnet and Ralph Meghames, International Transfer Pricing Journal, November/December 2014
Analytical Framework
Value Creation, Functional Analysis and Roles and Responsibilities

A Four-Step Process
Step 1—Value Chain Analysis

- **Value Chain Analysis**: Understand, in addition to an analysis of functions, how value is created in the Enterprise
  - Identify the key value drivers as part of a company’s value chain which influence the most the **Critical Success Factors** of the Enterprise within its industry
  - Identify the key value drivers in the value chain which can be held accountable for the Enterprise’s **major risks** within its industry and its chosen business model
Analytical Framework
Value Creation, Functional Analysis and Roles and Responsibilities

A Four-Step Process

**Step 1—Value Chain Analysis**
Analytical Framework
Value Creation, Functional Analysis and Roles and Responsibilities

A Four-Step Process
Step 1—Value Chain Analysis

Treatment of Data and Information

Survey Style
Interviews

Statistical Treatment
A Four-Step Process

**Step 2—Mapping of the Enterprise Functions, Assets and Risks with Value Creation**

- **STEP 1. Value Chain Analysis**
  - Value Driver #1
  - Value Driver #2
  - Value Driver #3
  - Value Driver #4
  - Value Driver #5

- **STEP 2. Functions**
  - Each person is a proxy for group-wide headcount involved in the activity

- **STEP 2. Risks**
  - Strategic
  - Operational

- **STEP 2. Assets**
  - Technology-related intangibles
  - Marketing intangibles
Risk and volatility can be approached in a two-dimensional scheme. The first dimension is the source of the volatility (external or internal) and the second dimension is the potential impact of the volatility (downside impact or upside impact allowing value creation).
Analytical Framework
Value Creation, Functional Analysis and Roles and Responsibilities

A Four-Step Process

**Step 3—Role, Responsibilities and Control of the Individual Group Entities**

**STEPS**

**STEP 1. Value Chain Analysis**

**STEP 2. Functions**

**STEP 2. Risks**

**STEP 2. Assets**

**STEP 3. Entities**

Define roles of the entities in the joint value creation and responsibilities in respect of the different value drivers and related risks.
Analytical Framework
Value Creation, Functional Analysis and Roles and Responsibilities

A Four-Step Process
Step 4—Relational Dynamics and transactions

- Step 4 involves the definition of how the relevant parties, now properly identified and assessed in terms of their role in the total set of relationships in the enterprise, can expect to be rewarded—transactions are the expression of the relationships

- This step includes analysis of how prices are set—ex ante and ex post

- Risk being the impact of volatility, the responsibilities of group entities for different risks drive the dynamics in establishing the final remunerations for those entities—ex post outcomes can only be understood and explained in view of those responsibilities

- For this reason, it is important to understand how prices are set for the intercompany transactions—reference should be how independent parties behave in similar relationships
III. Case Studies
Four Case Studies

- Pricing of Services
  - **Case Study #1**: Value Chain-Based Determination of TP system

- Pricing of Products
  - **Case Study #2**: Value Chain-Based Redesign

- Provision of Capital
  - **Case Study #3**: An Example of a Value Chain Analysis in Financial Services

- Entities’ Remuneration
  - **Case Study #4**: Value Chain for a Small Company
Case Study #1

Value Chain-Based Determination of TP system
The following slides present an illustration of a real case for a Company in the Service Industry

The following steps have been undertaken:

– Step 1: Understand how value is created in the Enterprise
  - Identify the key value drivers as part of a company’s value chain which influence the most the Critical Success Factors (CSFs) of the Enterprise within its industry
  - Identify the key value drivers in the value chain which can be held accountable for the Enterprise’s major risks within its industry and its chosen business model

– Step 2: Mapping of the Enterprise Functions, Assets and Risks with the Value Drivers

– Step 3: Define roles of the entities in the joint value creation and responsibilities in respect of the different Value Drivers and related risks
Value Chain Analysis
The Analytical Framework—Step 1

- **Step 1:** Understand how value is created in the Enterprise
  - Identify the key value drivers as part of a company’s value chain which influence the most the **Critical Success Factors (CSFs)** of the Enterprise within its industry
  - Identify the key value drivers in the value chain which can be held accountable for the Enterprise’s major risks within its industry and its chosen business model

- **Step 2:** Mapping of the Enterprise Functions, Assets and Risks with Value Creation

- **Step 3:** Define roles of the entities in the joint value creation and responsibilities in respect of the different value drivers and related risks
Value Chain Analysis
Step 1: Understand how value is created in the Enterprise through industry analysis (1/6)

The Industry is Fragmented and Operates in a Highly Competitive Market

... And a Clear Difference Distinguishes Standalone Entities From Full Services Providers

Larger Players Need to Innovate, While Increased Transparency Leads to Commoditization

....ETC.
Value Chain Analysis
Step 1: Understand how value is created in the Enterprise through survey techniques (2/6)

- Interviews with selected **Key People** within Company’s organization
- Use of **survey techniques** for the purpose of the interviews
- **Survey design based on industry analysis and findings**
  - CEO
  - Strategy
  - CCO
  - COO
  - IT/Processes
  - Key Account #1
  - Key Account #2
  - CSR
  - Western Europe
  - Finance —Western EU
  - US

“ […]

*What are the Industry's Critical Success Factors and Company’s main competitive advantage?*

*What are in your opinion the main risks and opportunities of the business?*

*What are the key functions of the Parent contributing to the success of the company?*

*Please describe the processes underlying the cited Value Drivers*

[ … ]
Value Chain Analysis
Step 1: Understand how value is created in the Enterprise through survey techniques (3/6)

Treatment of Data and Information
Value Chain Analysis
Step 1: Understand how value is created in the Enterprise through survey techniques (4/6)

The following question was asked to 15 key managers of Company in various functions: *Please indicate the CSFs in your business*

**CSFs Categories and Sub-categories**
Within all responses, Percentage related to each category

- **Customer Centricity**
  - Client services oriented
  - Key Accounts
  - Values
  - Brand
  - Talent Management
  - Network

- **Processes and systems**
  - Operational Excellence
  - Systems
  - Innovation
  - Etc.

- **Products and innovation**
  - Network
  - Etc.

**Number of data points: 70**

The following question was asked to 15 key managers of Company in various functions: *Please indicate the main risks in your business*

**Risks Factors Categories and Sub-categories**
Within all responses, Percentage related to each category

- **Financial Risk**
  - Financial Model Risk
  - Price Risk
  - FX/Inflation Risk

- **Strategic Risk**
  - Corporate Social Responsibility

- **Operational Risk**
  - Execution
  - IT Risk

- **Hazard Risk**
  - Etc.

**Number of data points: 60**
Value Chain Analysis
Step 1: Understand how value is created in the Enterprise through survey techniques (5/6)

Steps in the value chain
- ?
- ?
- ?
- ?
- ?

Critical Success Factors
- Network
- Processes and Systems
- Products and innovation
- Etc.
- Etc.

Major Risks
- Strategic risk
- Hazard risk
- Financial risk
- Operational Risk
- Etc.
Value Chain Analysis
Step 1: Understand how value is created in the Enterprise through survey techniques (6/6)

Steps in the value chain:
- Strategy and Network development
- Tools, Procedures and IT systems
- Product Conception and Development
- Etc.
- Etc.

Critical Success Factors:
- Network
- Processes and Systems
- Products and innovation
- Etc.
- Etc.

Major Risks:
- Strategic risk
- Hazard risk
- Financial risk
- Operational Risk
Value Chain Analysis
The Analytical Framework—Step 2

- **Step 1:** Understand how value is created in the Enterprise
  - Identify the key value drivers as part of a company’s value chain which influence the most the Critical Success Factors (CSFs) of the Enterprise within its industry
  - Identify the key value drivers in the value chain which can be held accountable for the Enterprise’s major risks within its industry and its chosen business model

- **Step 2:** Mapping of the Enterprise *Functions, Assets and Risks* with Value Creation

- **Step 3:** Define roles of the entities in the joint value creation and responsibilities in respect of the different value drivers and related risks
Value Chain Analysis
Step 2: Mapping of the Enterprise Functions, Assets and Risks with Value Creation (1/3)

- CEO & C Suite
  - Strategy
- Finance
- Human Resources
- Process Excellence and IT
  - Business Process Improvement
  - Etc.
- Operations
  - Procurement
  - Etc.
- Etc.
- Etc.

Sanitized Case Study
Value Chain Analysis
Step 2: Mapping of the Enterprise Functions, Assets and Risks with Value Creation (2/3)

Definition of Intellectual Capital: All the elements that contribute to making company successful in the long run
### Value Chain Analysis

Step 2: Mapping of the Enterprise Functions, Assets and Risks with Value Creation (3/3)

**Linking Critical Success Factors, Value drivers and internal processes and responsibilities:**

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<tbody>
<tr>
<td><strong>CSF</strong></td>
<td>Network</td>
<td>Processes &amp; Systems</td>
<td>Products &amp; innovation</td>
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<tr>
<td><strong>Sub-CSF</strong></td>
<td>Network</td>
<td>Part of a Group</td>
<td>Talent Management</td>
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<td>Brand</td>
<td>Values</td>
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<td>Efficiency: Cost/Price</td>
<td>Innovation</td>
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<td>Specific Products advantages</td>
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<thead>
<tr>
<th>Functions</th>
<th>Steps in the Process</th>
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<td><strong>CEO &amp; C Suite Strategy</strong></td>
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<td><strong>Human Resources</strong></td>
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<td><strong>Process Excellence and IT</strong></td>
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<td><strong>Business Process Improvement</strong></td>
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<td><strong>IT service Management</strong></td>
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<td><strong>Information Systems</strong></td>
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- **C/P:** C: Controls - P: Performs

Sanitized Case Study
Value Chain Analysis
The Analytical Framework—Step 3

- **Step 1:** Understand how value is created in the Enterprise
  - Identify the key value drivers as part of a company’s value chain which influence the most the Critical Success Factors (CSFs) of the Enterprise within its industry
  - Identify the key value drivers in the value chain which can be held accountable for the Enterprise’s major risks within its industry and its chosen business model

- **Step 2:** Mapping of the Enterprise Functions, Assets and Risks with Value Creation

- **Step 3:** Define roles of the entities in the joint value creation and responsibilities in respect of the different value drivers and related risks
### Value Chain Analysis

**Step 3:** Define Roles of the Entities in the Joint Value Creation and Responsibilities in Respect of the Different Value Drivers and Related Risks

<table>
<thead>
<tr>
<th>Transfer Pricing Responsibility Profiles Paradigm</th>
<th>Central (Headquarters)</th>
<th>Local</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment Centres</strong></td>
<td>Investment centres are profit centres, which are also responsible for investing in new products, services or work processes in order to enhance future profitability. It also assumes responsibility for the continuity of the enterprise</td>
<td>×</td>
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<tr>
<td><strong>Profit Centres</strong></td>
<td>Profit centres are responsible for achieving the maximum profit levels by increasing revenues and/or decreasing costs</td>
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<tr>
<td><strong>Revenue Centres</strong></td>
<td>Revenue centres are responsible for maximizing sales volumes while not exceeding the budgeted operating cost level</td>
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<tr>
<td><strong>Cost Centres</strong></td>
<td>Cost centres are responsible for operating as efficiently as possible and producing the budgeted quantity according to the agreed quality specifications and delivery terms</td>
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<tr>
<td><strong>Expense Centres</strong></td>
<td>Expense centres are responsible for delivering outputs according to the agreed quality specifications and delivery terms and within expense budget limits</td>
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</table>
### Value Chain Analysis

#### Conclusion

<table>
<thead>
<tr>
<th>Steps in the value chain</th>
<th>Functions involved</th>
<th>Risks</th>
<th>Assets</th>
<th>Indication of responsibility borne for performing functions</th>
</tr>
</thead>
</table>
| **Strategy and Network development** | - CEO & C Suite Strategy (Central)  
- Finance Strategy (Central)  
- Human Resources (Central) | - Strategic risks, Human and Intellectual Capital risks, Hazard risks,  
Financial risks, operational risks | - Strategic IC  
- Technical IC  
- Creative IC  
- Commercial IC  
- Operational IC | - Central  
- Central  
- Central  
- Central/Local  
- Local |
| **Tools, Procedures and IT systems** | - Process Excellence and IT (Central)  
- Business Process Improvement,  
- Etc. | | | |
| **Product Conception and Development** | - Operations (Central)  
- Procurement  
- Etc. | | | |
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Within the organization, Central influences and controls the majority of the factors driving success and can be held responsible for the major risks that the Company is facing.

Local companies seem to have a more dedicated role with a differentiating value proposition on their market relying quasi-exclusively on the Group’s intangibles.
Economic Analysis
Current system—TNMM

- The TP system seems aligned with value creation and contribution within the Company, as illustrated in the graph below:
Another round of interviews with Key People within the organization in order to
- Obtain their feedback on the formalized Value Chain
- Obtain their perception on the contribution of the various drivers of the VCA (use of survey techniques)

- CEO
- Strategy
- CCO
- COO
- IT / Processes
- Key Account #1
- Key Account #2
- CSR
- Western Europe
- Finance—Western EU
- US
Based on the information obtained during the interviews, we presented in indicative terms what is the relative contribution of the key enterprise value-drivers.

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<thead>
<tr>
<th></th>
<th>Respondent 1</th>
<th>Respondent 2</th>
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<th>Respondent 14</th>
<th>Respondent 15</th>
<th>Min</th>
<th>Q1</th>
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<th>Q3</th>
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<td>1 Strategy and Network development</td>
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<td>2 Tools, Procedures and IT systems</td>
<td>20%</td>
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<td>15%</td>
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<td>3 Products conception and development</td>
<td>15%</td>
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<td>10%</td>
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<td>4 Etc.</td>
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**50:50 Split assumption**

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<th>Local</th>
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FOR DISCUSSION PURPOSES
Case Study #2

Value Chain-Based Redesign
Various economic analyses performed to determine the contribution of each value driver:

- **Upstream activities** are the main value drivers
  
  Quantified: 50-60% contribution to value creation

- **Marketing (brand)** is the key communicator

  Quantified: 20-25% contribution to value creation

- **Sales**: sales, cost control and information

  Quantified: 20% contribution to value creation

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**Headquarters 75–80% : Sales ops 20–25%**
A Global Company Economic Analysis

1. Market Margin (Management Accounts)

Operating Margin

32% 18%

A B

2. Value chain analysis findings supported by Economic Analyses

25%

3. Identification of point within the TNMM range

Interquartile Range

A target margin 8%

B target margin 4.5%

Benchmarks

25%

Headquarters 75–80% : Sales ops 20–25%
Case Study #3

An Example of a Value Chain Analysis in Financial Services
In the example below, Entity B provides capital (with some other functions) and other core activities is performed by entity A.

Entity B operates from a location that was selected for its favourable regulatory regime.

**Entity A**
1. Strategy Development
2. Trading
3. Some capital management
4. Research
5. Back office

Circa 30 staff in total including 6 in senior management to serve Entity B and Entity A's own clients (different profile)

**Entity B**
1. Some capital management and holds all seed capital
2. Decision on successful trading strategies
3. 4 Staff members including 1 in senior management

**Third-party Clients**

**Advisory Agreement**
Intra-group transaction being evaluated

**Remuneration**

*How can VCA help price the advisory agreement?*
Post BEPS Analytical Process

Consider the industry value chain:
What drives value, commercial dynamics?

Business unit / group value chain:
How does the group operate, where is the group’s specific emphasis compared to industry value chain?
What are the steps in the value creation?
Are profits broadly in line with where value is created?

Identification, delineation and pricing of transactions

VCA:
Provide clarity on commercial rationale & relational dynamics amongst parties

Analyses of entities:
Map entities to the FAR Analysis

FAR Analysis:
Important functions (SPF / KERT?), risks and assets. Importance of people, capital and where risks are borne.
## Application of Value Chain in the Context of the Relational Dynamics

### Management Functions and Intangible Assets (Technology)

<table>
<thead>
<tr>
<th>Critical Success Factors</th>
<th>Product or Strategy Design</th>
<th>Origination (Raising of capital)</th>
<th>Investment Management</th>
<th>Back Office and Middle Office</th>
</tr>
</thead>
<tbody>
<tr>
<td>Innovation, Research, Technology</td>
<td>Access to seed capital, Client relations</td>
<td>Execution, Technology</td>
<td>Technology</td>
<td></td>
</tr>
</tbody>
</table>

### Functions By Value Driver

<table>
<thead>
<tr>
<th>Entity</th>
<th>Product or Strategy Design</th>
<th>Origination (Raising of capital)</th>
<th>Investment Management</th>
<th>Back Office and Middle Office</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity A</td>
<td>Research team, Technology team, Market risk team</td>
<td>Some investor relations</td>
<td>Trade team, Market risk team, Cash management team</td>
<td>Trade support teams, risk management, and back office team</td>
</tr>
<tr>
<td>Entity B</td>
<td>General Management Team (limited role apart from approval/ guidelines)</td>
<td>General Management Team, Fund raising, and own capital</td>
<td>Risk management</td>
<td></td>
</tr>
</tbody>
</table>

### Assets

<table>
<thead>
<tr>
<th>Entity</th>
<th>Product or Strategy Design</th>
<th>Origination (Raising of capital)</th>
<th>Investment Management</th>
<th>Back Office and Middle Office</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity A</td>
<td>Know-how, Technology, Software</td>
<td>Seed capital, Know-how</td>
<td>Technology, Trade process</td>
<td>Technology, Risk management systems</td>
</tr>
<tr>
<td>Entity B</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Risks Borne

<table>
<thead>
<tr>
<th>Entity</th>
<th>Product or Strategy Design</th>
<th>Origination (Raising of capital)</th>
<th>Investment Management</th>
<th>Back Office and Middle Office</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity B</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Entity responsibility

<table>
<thead>
<tr>
<th>Entity A primary responsibility/ Entity B</th>
<th>Entity A primary responsibility</th>
</tr>
</thead>
</table>
VCA Is A Starting Point for an Effective Communication with Tax Authorities

- Top-down approach by business line versus bottom-up
  - Holistic view as opposed to single entity and single transaction focus

- Information sources
  - Interview with mid and senior management
  - Review of processes in place, decision flows and functional organizational charts

- Objectives
  - Identification of critical success factors and key value drivers
  - Understand who carries responsibility for critical success factors and value drivers

- Contents
  - For each value driver, provide the corresponding functions, assets and risks
  - Review of Important Functions/SPF/KERT profiles and an analysis of the risks they manage, the assets they rely upon
  - VCA is part of the Masterfile
  - Mentions key legal entities as an introduction to the Functional Assets and Risks Analysis
People, Assets and Risks?

OECD says…

1. SPF/KERT, Important Functions, and risk management functions
2. Financial capacity to assume the risks

What does entity B deserve?

1. Where is the responsibility for the different steps in the value creation being handled?
2. Are the remunerations in line with value contribution?
   - CUP—implication in terms of risk sharing?
   - Profit Split—Determination of the share in the residual and remuneration for capital?
   - From a single Method to potentially several Methods together being relevant?
So, What If?

What if:

1. Entity B has no employees?
2. The seed capital was originally at Entity A and then shifted to Entity B?
3. Entity B was set up 1 year ago with former Entity A employees whilst Entity A has more than a decade of history

The above questions relate to the fact pattern. Answers would have a significant impact on the contribution to value creation of entities A and B. Methods selection and pricing of transactions would reflect the above.
Case Study #4

Value Chain for a Small Company
Case Study—Fact Pattern

- European manufacturer that produces components in Europe and Asia that it distributes into the European markets

- The firm has significant R&D functions and valuable technology
  - **Some of the R&D activities**, relating to new products and technology, are **critical success factors**.
    - These functions typically involve some of **the most senior management** of the firm
  - **Other R&D activities** are **simpler development / execution** type of functions

- The firm also has significant marketing functions
  - The **strategic marketing function’s** role includes the identification of **needs for new products** and providing **direction of the R&D functions** with respect to new product development and management of product portfolio.
    - These functions typically involve some of the **most senior management** of the firm
  - Other marketing activities are **trade marketing support functions**
In this case study, we will show how the profit split method can build on the value chain analysis to determine contribution to value creation on the entire supply chain—this method is more commonly used to set or to test transfer prices.
Case Study

- What would a value chain analysis look like?
- What is the involvement of key entities in the value chain?

Given the above value chain analysis, what transfer pricing techniques can be used to determine the remuneration of the various functions & activities?
Overview of Approach

Summary

- **Remuneration**
  - Routine Remuneration
  - Core functions and Intangibles—Brand/technology etc.

- **Consolidated Profit of Business Segment**
  - **Step 1**
    - Determine remuneration for all benchmarkable activities / assets
      - TNMM and / or CUP
  - **Step 2**
    - Residual Profit allocation by function and/or by entity (in this case by function)
      - Residual Profit Split Method

Once the residual profit has been determined, the key consideration is the definition of the appropriate split factor that should be used.
Step 1
Determination of Routine Remuneration

- **Question 1:** Which functions deserve a routine remuneration?
  - Decide based on VCA & FARA
  - Here, one could consider (based on facts & circumstances):
    - R&D execution—costs of 50 (out of 80) deserve a routine remuneration
    - Manufacturing—total costs of 400
    - Marketing—costs of 100 (out of 120) deserve a routine remuneration
    - Sales—total costs of 200

- **Question 2:** which method to use?
  - Typically rely on the use of the TNMM

- **Question 3:** What remuneration to provide?
  - Requires a benchmarking study (in general)
  - Example: Mark-up on total costs of 10% for routine R&D and 5% for routine manufacturing and marketing, return on sales of 3% for routine sales activities
### Step 2
What is Left after Routine Remuneration is Taken Out?

<table>
<thead>
<tr>
<th></th>
<th>R&amp;D &amp; Technology</th>
<th>Manufacturing &amp; procurement</th>
<th>Marketing including Brand development</th>
<th>Sales = 1 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Costs (a)</td>
<td>80</td>
<td>400</td>
<td>120</td>
<td>200</td>
</tr>
<tr>
<td>Costs of functions deserving a routine remuneration (b)</td>
<td>50</td>
<td>400</td>
<td>100</td>
<td>200</td>
</tr>
<tr>
<td>Mark-up or margin in % (c)</td>
<td>10% on costs</td>
<td>5% on costs</td>
<td>5% on costs</td>
<td>3% of sales</td>
</tr>
<tr>
<td>Mark-up or margin in € (d) = (c) × (b)</td>
<td>5</td>
<td>20</td>
<td>5</td>
<td>30</td>
</tr>
<tr>
<td><strong>Residual Profits (e) = 1 000 – Σ(d) – Σ(a)</strong></td>
<td></td>
<td></td>
<td></td>
<td>140</td>
</tr>
</tbody>
</table>
Step 2
There are Various Ways to Split the Residual Profits

Value the contribution of IP to the overall Value Creation Process

**Compensation Data**
- **PROs:** Convenient as it relies on internal data
- **CONs:** Sensitivity of communication of compensation data, nature of factors that influence compensation data

**Investments**
- **PROs:** Relies on data that can be traced
- **CONs:** Analyses rely on a large number of assumptions

**Game Theoretical Approaches**
- **PROs:** Ideal to reflect bargaining positions of transacting parties
- **CONs:** Quality and reliability of estimates and assumptions

**Financial Data/Agreements Third Parties**
- **PROs:** Based on market data
- **CONs:** Degree of comparability, quality of data
Residual Profit Split Method Application Requires Two Steps

Based on the group value chain and value drivers, design the most suitable analysis to split the residuals. In this case, assume that investment approach is most suitable. Assume that its application shows that 60% of residual profits in a given year attributable to technology and 40% to marketing and branding.

1. In the case of two identified intangibles, one option could be to isolate and value one intangible outside the RPSM.
2. Another option consists in valuing the two intangibles as part of the same RPSM model.

Ability to define an economically robust split factor is essential to apply this method.
The residual profit split and transfer pricing methods in general can be used both to price transactions or to assess overall value chain.
Conclusion

- Application of the profit split method should always be based on a thorough understanding of the VCA & FARA
- Profit split method is not global apportionment
- Method is particularly suitable to situation where several parties have key “DEMPE” functions
- The identification of robust and appropriate split factors is an important aspect of the analysis
- The method can be applied to set transfer prices, to test transfer prices or to determine contribution to value creation of the entire value chain as in this example
Take-Aways

- Understanding Value Creation is a **must have**

- Value Creation is about identifying the activities that enable to maintain a high level of profits in the long run

- This is very much Company specific: **your chance to tell your story!**

- Economic analysis, which is about pricing transactions between entities, should be embedded in this framework
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