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The State of the Art in Comparability for Transfer Pricing

The past 15 years, and even more so the last 5 years, have shown a marked growth in popularity of the transactional net margin method. The increasing use of this method has led to a tendency towards reliance upon standardized benchmarking searches, at the expense of more comprehensive and economically sound approaches. Recent developments in transfer pricing show that this tendency may now come to an end.

1. Introduction

Since the introduction of the 1995 OECD Transfer Pricing Guidelines (OECD Guidelines), transfer pricing has grown exponentially as a perceived revenue source, and has become a key focus area for tax authorities. The financial and operational impact for multinational enterprises (MNEs) has expanded correspondingly, and public awareness of the phenomenon increased significantly.

The past 15 years, and even more so the last 5 years, have shown a marked growth in popularity of the transactional net margin method (TNMM). The increasing use of the TNMM has led to a tendency towards reliance upon standardized benchmarking searches, at the expense of more comprehensive and economically sound approaches. Recent developments in transfer pricing show that this tendency may now come to an end. This is a consequence of (clearer) requirements from transfer pricing stakeholders (tax authorities, courts, MNEs) to go back to the fundamentals underlying transfer pricing, in other words, the setting of prices within an MNE, in line with what third parties would have negotiated in similar circumstances: the arm's length equation.

Given that intra-group terms and conditions should mirror those of third parties for similar transactions, the primary issue for judging whether a transaction can be deemed to be arm's length is comparability. Thus, comparability analysis is at the heart of the proposed revisions of the OECD Guidelines,[1] and recent court cases in various countries illustrate the critical importance of the issue. In this context, this article indicates that:

- comparability analysis involves firstly mapping the (terms and) conditions applied to intra-group transactions, in the context of a certain given relationship between the transacting parties, and taking into account the economic circumstances. Comparability therefore should be viewed in a broad sense. This key message will be illustrated by recent court cases as well as more practical case studies;
- comparability analysis involves then selecting appropriate analytical methods, identifying good comparables (whether transactions or companies) and performing, if appropriate, sound economic adjustments to enhance comparability. Comparability, and the arm's length principle deserve more than standardized comparables search processes and hazardous outcomes. The authors have selected a few topics to illustrate, including the concept of independence in a benchmarking study and functional comparability; and
- once comparables have been identified, they may need further refinements to be effective. The topic of adjustments is illustrated by two examples:
  - how to adjust comparables data given the new financial and economic paradigm; and
  - how to adjust for differences in economic circumstances between the tested party and the comparables.

2. Comparability in a Broad Sense

2.1. "Similar circumstances" include similar commercial and financial relations

Conclusions regarding comparability in transfer pricing are subject to the analysis of the five "factors determining comparability", described in the application guidance of the OECD Guidelines in respect of the arm's length principle. These are:

- characteristics of property or services;
- functional analysis;
- contractual terms;
- economic circumstances; and
- business strategies.

The "five factors" have become the standard reference in performing comparability analyses; in this respect the proposed revision of Chapters I-III has kept the comparability factors unchanged but incorporated some clarifications.

One important aspect, however, is lacking in the comparability analysis, as defined by the OECD, namely that it concerns the relations between the parties. Transactions are the materialization of the commercial or financial relations between different parties. Commercial and financial relationships, whether between independent or associated enterprises, can take many different shapes.

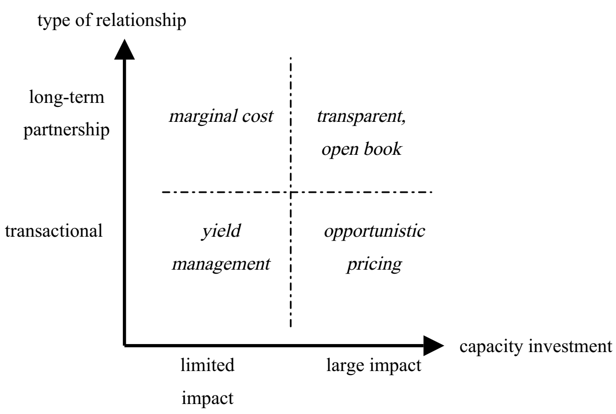
* **NERA Economic Consulting. The authors wish to thank Amanda Pletz, NERA Economic Consulting London, for her comments.**

1. On 9 September 2009, the OECD issued its Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines.

They can be incidental, involving one or a limited number of transactions, or can be of long duration, with clear intentions of cooperation. Conditions of certain transactions will not be comparable categorically with those of similar transactions, but only with those applied for transactions in the context of relationships of a similar type. Furthermore, relationships constitute a different context depending on the impact on investment in capacity. If one of the parties has invested heavily, e.g. by building a manufacturing plant and hiring a large number of employees, and that investment turns out to be obsolete earlier than foreseen, then the impact on the price (i.e. terms and conditions) of transactions between the parties will be different depending on the relationship. If the relationship is purely transactional, this would be the risk of the investing party. However, in the context of a long-term cooperative relationship, parties will find a way to share the consequences of an unforeseen event.

Table 1 illustrates the effects of capacity investments and types of relationships on the nature of the approach of the pricing process,[2] when entered into by independent parties in the market.

Table 1: Approaches to pricing in the market



These circumstances should be considered as a starting point of the comparability analysis, as the arm's length principle requires that "*similar circumstances*" be observed in order for the transactions or companies to be considered as sufficiently comparable. They include both the context of the commercial and financial relationship between the parties and the "economic circumstances" surrounding the transactions. The fourth factor defines the economic circumstances as those relating to industry and market. The relationship is referred to in the fifth factor, business strategies, but the scope of that factor deserves to be broadened to the relational context more generally. This exercise is all the more delicate given that the types of relationships in which dependent companies are involved and capacity investments required will in most cases (as flagged in the comments to the OECD Guidelines) be perceived as different from those of independent companies.

In the view of the authors, it is the fifth factor, described as "business strategies", that should be the appropriate place for giving attention to the economic and financial relationship of the parties. This is indeed the factor that should absorb the relational context. Strategies are not an isolated or incidental phenomenon, but the strategies and the roles and responsibilities that transacting entities assume therein, find a place in the context of their relationship.

2.2. Case law illustrating the importance of the circumstances

The importance of relations in transfer pricing and the necessity of a broader comparability analysis have been recognized in recent court decisions, notably *Dixons* and *GE Capital*.

The *Dixons* case[3] in the United Kingdom is quite representative in this respect. In their ruling, the UK's Special Commissioners presented a detailed, economics-based comparability analysis of what had been used by the taxpayer as comparable uncontrolled price data to support an offshore structure. In that analysis, particular importance was given to relative bargaining strength. Each data observation was dismissed by the Special Commissioners as insufficiently comparable to be reliable or as unsuitable for adjustment to account for differences in comparability. The Special Commissioners agreed with HMRC's expert economist that it would therefore, *in view of the commercial and financial relations* that existed between the parties, have been appropriate to adopt an approach based on a profit split approach. The case highlights the limitations of the current approach in transfer pricing that directs its focus to the "*testedparty*" and tends to ignore the relations between the *parties involved in the transaction(s) under scrutiny*. As a consequence, issues like bargaining power of the parties – indispensable in analysing the arm's length character of pricing – remain underexposed.

The recent decision in Canada in favour of GE Capital Canada raises more explicitly than before the issue of the parent-subsidiary relationship in comparison to the operational relationship.[4] The Tax Court of Canada ruled that GE Capital was entitled to deduct the USD 130 million guarantee fee it paid to its US parent to boost its credit rating and to facilitate borrowing. The Canadian Revenue Agency (CRA) argued that the guarantee fee was not warranted because of the relationship and association between GE Capital Canada and its US parent: the "implicit support" granted by the parent company would be, according to CRA, recognized by financial institutions anyway, and therefore the guarantee fee was unnecessary. The Court has rejected such reasoning and has extensively used economic analytical expertise to identify what the Canadian subsidiary "stand-alone" would have to pay to acquire its status as a borrower, in order to assess what arm's length fee GE Capital should

2. Fris and Gonnet, "ReAL Transfer Pricing", *BNA Tax Planning International* (15 June 2006).]
3. Special Commissioners, *DSG Retail Ltd v. HMRC* (23 April 2009) (*DSG Retail*).
4. *General Electric Capital Canada Inc. v. The Queen* (4 December 2009).

have paid as a stand-alone entity. In doing that, the judge acknowledged that the relationship and association with GE in the United States impacts the credit rating of GE Capital Canada, as such requiring some adjustments to the basic stand-alone rating. Some argue that consideration of the parent-subsidiary relationship contradicts the arm's length principle:

> Despite the taxpayer victory, practitioners said they were alarmed that the judge included consideration of the US parent's "implicit support" in valuing the guarantees, saying consideration of *the parent-subsidiary relationship*, as requested by CRA, appears to contradict the arm's length principle.[5]

In this case, the extent to which financial institutions would have taken the relationship into consideration is not clear, as it relies on the facts and circumstances of the case. In the view of the authors, however, the judgment confirms that the stand-alone or separate entity approach will not prevent an analysis of the relationship of the transacting parties, which, as stated above, is the core of any comparability analysis. An important feature of the decision is the consideration of the interplay of the shareholder relationship with the operational fact pattern. The fact that all decisions impacting the subsidiary's rating were taken by the parent (although not in its capacity as shareholder) is established, but the analysis leaves a number of interesting questions unanswered, for example, concerning potential permanent establishment issues.

2.3. Mapping the circumstances in practice

In more practical terms, transfer pricing practitioners must include in their comparability analysis an in-depth review of the relationships involved in controlled and uncontrolled transactions.

For instance potentially comparable uncontrolled transactions may be dismissed given that the relationships involved in the uncontrolled transaction differ from those involved in the controlled transactions. As an illustration, consider a retail group that expands and operates mostly in an integrated manner with distribution subsidiaries. The group distributors cannot necessarily be compared with the few franchisees that the group uses for certain territories. A typical comparability analysis would identify that the markets are different and therefore that internal distributors and external franchisees cannot be compared. In fact, one of the major reasons which may legitimate the rejection of the comparable uncontrolled price method might be related to the nature of the relationship that the group has with its internal distributors in comparison with the nature of the relationship with external franchisees: third-party franchisees may operate as an investment centre with the overall responsibility for the continuity of their business with significant responsibilities in relation to a wider range of functions, in comparison to internal distributors acting as a revenue centre with strictly a dedicated sales role. In terms of risks, third-party franchisees may operate with a greater level of risks, as the franchisee carries the risk of its own business. The distributors are not carrying such risk, as they are supported by the group.

Conversely, the review of the relationship between controlled and uncontrolled transactions may lead to the selection of the uncontrolled transaction as comparable. As an illustration, a commodities group distributes both through subsidiaries and through unrelated distributors. Among the unrelated distributors, one is the partner with which the group maintains the closest links and is involved in comparable cooperative relationships. Reasons behind the tight links are the duration of the relationship and the size of operations (this third-party distributor is the largest third-party distributor of the group). The cooperative relationship is formalized in a master agreement entered into and executed by the two parties. The group and the third-party distributor are therefore in the following situation: they work together to achieve an optimal result, and both parties have an interest in keeping the partner in the cooperation in good shape and motivated to contribute to the joint value creation. In this respect, the circumstances of the deal and the relationship are very similar to that of intragroup transactions. Conversely, with smaller distributors, the group handles relationships which are not comparable (e.g. nature of the transactions, of the relationships) given that they enter into a transactional versus a long-term cooperative relationship, a one-off deal versus a partnership.

As a summary, comparability analysis involves a broader analysis than what is usually done in transfer pricing: it involves establishing (whether ex post or ex ante) the arm's length character of (terms and) conditions applied to transactions, in the context of a certain given type of relationship, and taking into account possible differences in the economic circumstances.

3. Comparability Necessitates Good Comparables

3.1. Finding good comparables

Once a transfer pricing method is selected, the analysis requires identifying comparable transactions or comparable companies, which will serve as external market references.

As indicated above, the comparability analysis will follow the OECD factors for comparability. In the revised chapters I-III, the OECD has reaffirmed the necessity for obtaining good comparables in order to meet the arm's length standard. The new wording from the OECD is a reaction to the use of mechanical approaches towards comparables searches and a standardization of the exercise. This statement is shared by a number of transfer pricing practitioners across the globe: "for a number of years, there has been an increased reliance upon standardized searches with rather generic samples…".[6]

5. "Tax Court ruling favors GE Capital in landmark transfer pricing case", *BNA Transfer Pricing Report* (17 December 2009) (emphasis added).
6. Danny Oosterhoff, "Proposed Revision of OECD Guidelines: The Importance of Facts and Circumstances", 17 *International Transfer Pricing Journal* 1 (Jan/Feb 2010), at 3..

Given the extensive use of the TNMM, the standardization mainly concerns the search for comparable companies, not so much the search for comparable transactions (the comparable uncontrolled price method is used on rare occasions). Emphasis shifts therewith from testing (terms and) conditions of transactions to testing outcomes of parties deemed to be involved in similar transactions. In a TNMM context, comparables are generally selected by relying on standard screenings in a mechanical manner.

Two types of issues are particularly sensitive in this context:
– Are comparables "independent"?
– Are comparables performing the same functions and bearing similar risks?

Regarding *independence*: what is an independent comparable? This question is basic and is the starting point of any arm's length comparables search exercise. The OECD has indeed reaffirmed that dependent companies may not be used in any case for transfer pricing setting or testing.:

> The Working Party discussed these issues and concluded that controlled transactions should by no means be used as the basis for a transfer pricing adjustment. This would be contrary to the wording of Article 9 itself and to the arm's length principle which require the taxpayer's commercial or financial relations with its related parties to be compared with commercial or financial relations between independent enterprises. Similarly, information on competitors' controlled transactions that may be gathered by a taxpayer would generally not be sufficient to support its transfer pricing policy.[7]

Therefore, selected comparables must be independent. The interpretation of this requirement may differ from one country to another in line with the interpretation of tax authorities. What may in certain occasions or countries be observed are screenings based on the database "independence" classifications. These standard screenings which are quite usual may reject companies owned by one holding company for instance, or by two parties which own 50% each. On which grounds must these potential comparables be rejected? The independence criterion aims at removing companies the financial results of which may be influenced by (non-arm's length) intra-group transaction flows. Applying mechanical search steps removes many companies that are actually independent in the OECD sense: the operational results of a company that is owned by a holding company which books only financial items in relation to its subsidiary are arm's length. The same is valid for the results of a company owned by two parties or owned by one party holding 100% of the shares. A strictly mechanical approach to independence distorts the final sets. The same issue goes with the systematic rejection of companies with subsidiaries: consolidated figures may be used to neutralize any potential intra-group transactions that may influence the selected company's results. The consolidated approach may be used only to the extent that the activities of the group of companies (consolidated) are similar to those of the tested party.

The *functional analysis* is most often the core of a comparability analysis. As part of the comparable uncontrolled price method, this involves identifying the functions performed and risks incurred by the (unrelated) parties to the tested transaction. As part of other methods, such as the resale price method, the cost-plus method or the TNMM, the review consists in ensuring that the selected comparables perform similar functions and bear similar risks as the tested party. The functional comparability is key to any transfer pricing analysis, as emphasized and reaffirmed in the OECD Guidelines[8] and in the proposed revision of Chapters I-III:

> In some cases, it has been argued that the relative lack of accuracy of the functional analysis of possible external comparables might be counterbalanced by the size of the sample of third party data; however quantity does not make up for poor quality of data in producing a reasonably reliable analysis.[9]

In the view of the authors, the review of the functional and risk comparability primarily involves an understanding of the industry in which the transaction takes place or the tested party operates. The industry analysis will allow for the identification of which types of market players may operate under similar circumstances as the transacting parties. This analysis typically includes a general overview of the industry, with details about its economic characteristics (market structure), the industry value drivers, the industry profit pool, the competitors and the current trends. It should also include information about the group's positioning and the role of the group entities in this positioning, the interaction with other players and the differentiating factors. In this respect, an industry analysis will also assist in determining what transfer pricing method will be used and ultimately what comparables will be selected.

As an illustration, consider a retail group involved in the distribution of premium branded products; in the industry in which the group operates, the combination of good product design, excellence in manufacturing and effectiveness in marketing campaigns are the drivers for success and profitability. Marketing costs involved are significant compared to other industries, and are generally borne by the local distributors, even though they may not be fully responsible for the marketing campaigns they finance. A potential search for comparable companies operating in similar circumstances as the tested parties (the local distributors) requires an in-depth understanding of the market structure. In this case, the closest comparables may be multi-brand distributors, provided that:
– they can be regarded as independent, i.e. their financial results are not potentially distorted by any transfer pricing policies;
– they operate as multi-brand retail distributors;
– they distribute premium branded products, that they do not own the brand;

7. Comparability, Public invitation to comment on a series of draft issues notes (10 May 2006).
8. Para. 1.20, OECD Guidelines.
9. Revised OECD Guidelines, Chapters I-III.

- they are involved in the co-marketing of the brands that they distribute, together with the brand owner; and
- they operate under a similar level of operational risks as the tested party.

Understanding the market structure, in advance, prior to undertaking the database downloads, is necessary. This allows an identification of the typology of market players and the targeting of the most appropriate category. This analysis may well lead to the conclusion that the profile of targeted companies does not (or no longer) exist in the market, thus requiring a change in the method selected or in the approach. The typical case of EU car distributors is quite representative in this respect; the scarcity of independent players demands alternative approaches.

Most of the time, this industry analysis is lacking and is not done in the context of comparable searches. This has two consequences:
- comparables searches are then done mechanically and results are hazardous and inconsistent; and
- the outcome of the comparables search cannot be used reliably for price setting or for price testing purposes.

The practice of past years with respect to comparability analysis shows a certain loosening on comparability, with the emergence of standardized comparable searches and hazardous outcomes. In the view of the authors, the loosening on comparability involves loosening in the application of the arm's length standard. The authors therefore welcome recent efforts from the OECD to insist on the importance of performing reliable comparable analyses. The fact that judges in many jurisdictions have entered the economic domain and reaffirmed the necessity of applying reliable comparability analysis, confirms the requirement for greater rigor in comparability.

3.2. Case law illustrating the importance of good comparability

The above-described *Dixons* case[10] in the United Kingdom is quite representative of a broad comparability analysis, involving a detailed and extensive analysis of what had been used by the taxpayer as comparable uncontrolled prices.

In France, a recent case demonstrates that the French courts no longer hesitate to enter the economic domain and to review the appropriateness of analytical methods selected and comparables accepted. In *Man Camions*,[11] a French subsidiary of a German group selling trucks on the French market used the resale price method to set prices, in line with the gross margins of comparable French companies. This method apparently led to losses for a few consecutive years for the distributor.

In this case, French tax authorities used a TNMM to challenge the losses and ultimately the prices/gross margins.[12] Not only did the French Court eliminate two of the five European companies included in the benchmark of the French tax authorities because they were not independent, but more importantly, the Court concluded that the French market for trucks is not comparable in itself to other European markets for similar goods, due to the dominant position of Renault, which is historically a dominant player on the French market. By challenging the appropriateness of the comparables and by the fact that they were operating in Europe and not in France, the judge highlighted that (1) the tax authorities must demonstrate that comparables are sufficiently comparable (!) and (2) the EU market may be used as a reliable reference only if it can be demonstrated that economic circumstances in which the transactions take place (such as market characteristics) are similar in the European Union and in France. The next question is, of course, how to proceed once it is established what the differences are. In the specific case, the translation of the different circumstances into appropriate adjusted conclusions ("the burden of proof") was on the French tax authorities, and this burden of proof was not met. It is noteworthy that the relevant French legislation has changed, effective from 1 January 2010, such that the burden of proof is basically shifted to the taxpayer.

This case represents effectively the first time that a French court has gone so far in reviewing the economic relevance of both parties' benchmarks, thereby opening an interesting direction for taxpayers. It demonstrates that both the tax authorities and taxpayers should maintain higher standards for comparability analysis and consequently for comparability in the companies used in benchmarks.

4. Comparability Necessitates Good Adjustments

4.1. The effectiveness of adjustments

As seen above, comparability analysis involves the selection of the appropriate transfer pricing method, as well as the selection of good comparables. As illustrated above, the circumstances in which the potential comparables operate may generally differ from the circumstances in which group companies operate. Should this be the case, adjustments will be required.

The OECD Guidelines state that:

> material differences between the compared transactions or enterprises should be taken into account. In order to establish the degree of actual comparability and then to *make appropriate adjustments* to establish arm's length conditions (or a range thereof), it is necessary to compare attributes of the transactions or enterprises that would affect conditions in arm's length dealings. Attributes that may be important include the characteristics of the property or services transferred, the functions performed by the parties (taking into account assets used and risks assumed), the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties.[13]

10. See *DSG Retail*, note 3.
11. Administrative Court of Appeal of Versailles, *Société Man Camions et Bus*, 08VE02411 (5 May 2009).
12. Proposed revision OECD Chapters I-III, Public invitation to comment.
13. Para. 1.17, OECD Guidelines (emphasis added).

The revised Chapters I-III reaffirm the appropriateness of transfer pricing adjustments:

> The need to adjust comparables and the requirement for accuracy and reliability are pointed out in these Guidelines on several occasions, both for the general application of the arm's length principle and more specifically in the context of each method. As noted at paragraph 1.33, to be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. Whether comparability adjustments should be performed (and if so, what adjustments should be performed) in a particular case is a matter of judgment.[14]

The range of possible adjustments is quite broad, and as stated by the OECD, adjustments will be performed only if appropriate and if reliable data can be used. Examples of adjustments that may apply depending on the circumstances of the case include:
- accounting for differences in the macro-economic environment (e.g. economic crisis adjustments); and
- accounting for differences in economic circumstances (country-specific adjustments).

4.2. Economic crisis adjustments

The relatively abrupt, exogenous decline in aggregate demand during 2008-2009 had a direct impact on sales and profits that varied by sector and across companies within sectors. Arm's length profitability benchmarks need to reflect these economic conditions, as well as the differences across sectors and companies in terms of the direct financial impact of the meltdown.

Under these circumstances, it is a challenge for most MNEs to use their "old" transfer pricing system to set transfer prices for a crisis year. Generally, transfer pricing systems have been designed for "normal" business circumstances, and therefore are not appropriate for specific downturn circumstances. This may lead MNEs to reconsider the transfer pricing method and/or the comparables used. As described above, a broad comparability analysis, including an analysis of the relationship between the transacting parties involved, allows MNEs to identify what is the most appropriate, given the circumstances.

Which comparables to use is not the least complex subject. As known by transfer pricing practitioners, financial data of comparables are available 12 or 18 months after the closing of the year. This is notably true for European private companies, from which European comparables are extracted. This would lead MNEs to set prices based on data reflecting pre-crisis conditions. This is obviously not an appropriate solution and may lead to a non-arm's length allocation of profits among different group entities (and countries).

Adjustments to the comparables may then be necessary. The following adjustments are generally envisaged: [15]
- using the most recent comparables data including interim results and forecasts. This type of data is available only for quoted companies. Only certain jurisdictions (e.g. United States, China) use quoted companies as a basis for identifying a panel of comparables. This solution does not work in the European Union where private companies are used;
- using an alternative time frame. Weighted-averages are normally used to smooth out the effect of single years and to obtain a broader view on a business cycle. Under the current circumstances, using 2008 data to set 2010 prices may be more appropriate compared to using 2005-2008 weighted averages; and
- performing appropriate adjustments to the financial profitability observed at the level of the comparables:
  - a regression type analysis can be done to establish the systematic relationship between changes in sales and profitability. The reliability of such an approach heavily depends on the number of observations, and the reliability of the underlying data; and
  - a cost structure analysis consists in assessing the level of variable and fixed costs of the comparables and assessing the impact of a decrease in sales volumes on the net profitability of the comparables. The difficulty in this approach is that the financial data of the comparables do not display distinctly the split between variable and fixed costs. However, if comparables have been correctly selected, they should have a cost structure that more or less will mirror that of the tested party, for which the split variable versus fixed costs is known.

As indicated above, the use of such types of adjustments must be done with great care, with a perspective on the overall context of the transaction and the relationship between the transacting parties. This involves a broad comparability analysis to understand how third parties would have (re)negotiated under similar circumstances.

4.3. Economic circumstances adjustments

A number of economic factors can contribute to differences in risk profile and cost structures, and consequently influence profit margins of companies. For example when considering a tested party operating in Location *A*, with the only available functional comparable companies being based in Location *B*, a typical transfer pricing question would be: Do the margins observed for the comparables in Location *B* appropriately reflect those that can be expected for the tested party in Location *A*?, If not, where do the differences lie and what adjustments may be performed?

The answer to this question is likely to lead to an evaluation of both the short- and long-term cost of capital of the tested party in Location *A* to that of the comparables operating in Location *B*.

14. Revised Paras. 3.46 et seq.
15. N. Mori, N. Mert-Beydilli and G. Poole, "Transfer Pricing in Troubled Times", *Tax Management Transfer Pricing Report* (15 May 2009).

Typically, when considering companies operating in different locations, the following factors influence the return that a company would expect to earn: political risk exposure, credit market conditions (in particular the risk of default), regulatory differences, differences in payment terms, and other business and market-related risks,. These differences can have a significant impact on the margins observed.

As an illustration, searches were done by NERA Economic Consulting for companies performing engineering and specialized construction services in two different markets:
– one search focused on companies in more mature, less risky European markets; and
– one search focused on similar companies, functionally comparable to the European set, operating in riskier (with respect to above-outlined risk factors), less mature markets.

The selected companies in A & B are functionally comparable, the main difference between them being the economic conditions in which they operate. Table 2 shows the range of results observed for these comparables over the period 2006 to 2008.

Table 2: Comparison of markup on total cost comparables *

	2008 (%)	2007 (%)	2006 (%)
First quartile			
less risky market	0.77	0.73	0.99
riskier market	11.80	8.98	4.86
Median			
less risky market	2.08	2.88	2.37
riskier market	23.18	19.67	18.44
Third quartile			
less risky market	4.54	6.18	6.03
riskier market	46.92	43.05	42.89

* This scenario will be valid only for companies operating in riskier markets, and being dependent on those markets.

Source: Orbis Database published by Bureau van Dijk

As shown above, significant differences can be observed between comparables operating in different environments. Although illustrated as a markup on total cost, this deviation in margins can be observed when considering any of the profit level indicators (e.g. return on capital employed (ROCE))

When third-party evidence cannot be observed (lack of comparables in certain geographies, like in the above case of Location *A* versus Location *B*), adjustments must be performed to appropriately account for differences in economic conditions between the tested party and the comparables. To adjust for these economic differences, one needs to understand how these differences impact on the return that a rational investor would expect to earn if it were to invest in a particular location.

Consistent with the differences in margins observed above, and in accordance with finance theory and the risk return trade-off, an investor investing in a riskier investment would expect a higher return. Therefore, keeping this principle in mind, the comparables in Location *B* can be adjusted to reflect the market risk factors associated with operating in Location *A*. Thus, the relationship between the risk and return trade-off can mathematically be expressed as:

$r_e = r_f$ + risk premium

where r_f is the risk-free rate and the risk premium is the additional return required by an investor to invest in a particular market relative to its risk-free rate.

The risk premium typically encompasses the risks associated with a particular investment including political risk, credit risk and other business and market specific risks. r_e refers to the return that an investor would expect to earn on its investment, given the risk profile.

Example

If the risk-free rate is 4%; the risk premium in Location *A* is equal to 10%; and Location *B* is equal to 2%; and the expected return of an investor wishing to invest in Location *A* is equal to 14% while in Location *B* the expected return of an investor is equal to 6% (assuming the beta factor, a measure of undiversifiable risk, is equal to 1).

The return to investors will be at least 8% higher in Location *A* than that in Location *B*, to compensate the investors' additional risk that they will assume for investing in Location *A*.

With this in mind, the operating profit of the comparables can then be adjusted (upwards in this case) by estimating the additional profit margin that a company operating in Location *A* would expect to earn, given the higher risk compared to Location *B*.[16] This additional profit can be derived from the financial impact of this differential on the cost of capital. The impact of this adjustment on the return of capital employed (ROCE) can mathematically be described as follows:

$$\text{ROCE}_{\text{Adjusted Comp 1}} = \text{ROCE}_{\text{Unadjusted Comp 1}} + \text{Risk Adjustment Factor}$$

where the:

$$\text{Risk Adjustment Factor} = \frac{\Delta\text{EBIT (Adjusted – Unadjusted)}}{\text{Capital Employed}}$$

where Δ refers to adjusted EBIT compared to unadjusted EBIT, given the higher cost of capital.

16. When working with emerging economies, country risk premiums are often difficult to find. In these cases, one can still estimate the expected cost of capital and in particular working capital, by multiplying the equity risk premium in Location *B* by the relative standard deviation of stock prices in Location *A* to Location *B*. The difference between the risk premium in Location *B* and that of Location *A*, would be the additional return expected by an investor given Location *A*'s economic risk profile. Mathematically this can be shown as:

$$\text{Risk Premium}_{\text{Location A}} = \text{Risk Premium}_{\text{Location B}} \times \text{Relative Standard Deviation}_{\text{Location A}}$$

For more information, see A. Damodaran, *Investment Valuation Tools and Techniques for Determining Value of Any Asset* (2002), second Edition, at 167-168. Other source available include Morning Star, International Cost of Capital Report.

5. Conclusion

Comparability and arm's length are inextricably linked concepts; a loosening with regard to comparability means losing sight of the arm's length character of transactions and the outcomes thereof. Comparability analysis, following the five factors of comparability, must be done in a broad sense. The broader commercial and financial relations between parties have an impact on how they enter into transactions and how they agree on terms and conditions, i.e. the "price", of their transactions.

Further, the process of testing the arm's length character requires the identification of suitable comparables and the application of appropriate adjustments. The effects of the recent economic crisis and of differences in economic circumstances have been considered. However, even applying adjustments may lead to indicative results only, and is insufficient to draw final conclusions in respect of the arm's length character of prices.

Companies should always be in a position to explain and justify their results in the event that these end up outside the so-called "arm's length range". In the most typical approach to comparables searches, some 50% of the (qualifying) observations are *outside* that range. Technical adjustments applied can bridge some of the gaps. But explaining its own pricing behaviour as satisfying the arm's length principle should take place on the basis of a company's own results of its commercial and financial operations. The attribution thereof to the parties to the intercompany transactions is, at the end of the day, the real role of transfer pricing.