Value Creation Analysis for Transfer Pricing Purposes

The author presents a practical and pragmatic option to perform value creation analysis for transfer pricing purposes. Following Michael Porter’s concepts, this article addresses five steps that can help the reader understand and follow an economic analysis to align a transfer pricing policy with a company strategy.

1. Introduction

Although the OECD might have included the “value creation” term only with the purpose of encouraging profits to be taxed where value is created, the transfer pricing community is interpreting the concept and how it should be applied in quite different ways. Some countries already demand taxpayers perform a value creation analysis with numerical representations. Despite its relevance, the definition for this concept was not included in the OECD Transfer Pricing Guidelines 2017 glossary.

The first logical question is whether a value creation study is necessary at all. In some countries, the analysis is already a documentation compliance requirement. On the other hand, there is no requirement for an industry analysis at a Master File level, which is unfortunate because there is a need to understand the industry in which a company operates in order to identify real value drivers, differentiation among competitors and cycles. Therefore, a good value creation analysis constitutes not only an additional compliance factor but can also be enlightening for transfer pricing purposes. Apart from including an analysis of the industry, the value creation analysis will allow the reader to understand whether companies are taxing their income there where profit is being created, i.e. whether the transfer pricing policy makes sense. From the taxpayers’ perspective, in the case of an audit, it will help them in the process of planning, arguing and sustaining a reasonable transfer pricing policy from a group perspective.

The economic circumstances of a particular transaction and a comparability analysis can only make sense and be reasonable if the overall situation within a specific industry is understood. In other words, it is difficult to make sense of one single transaction independently if the company’s situation and strategy is generally not clear.

2. The Concept of Value Creation

The idea of value creation was developed by Michael Porter in 1985. He also worked on other concepts like value chain, competitive advantage and strategy. His theories have been used as tools for economic and management purposes for the last three decades. Professor Porter has developed different ideas that have guided economic policy throughout the world. His theories are still valu-
able because they are flexible and adaptable to new business models and technologies. They have been the pillars that support other newer management and strategy theories and will probably remain so for a long time. In all management and economic definitions that have to do with business strategy, Porter seems to be the one that has contributed more to business strategy concepts and the economic analysis of companies.

Before exploring the concept of value creation in more depth, the author will explain other concepts that are used constantly throughout this article and which are extremely relevant for the VCA.

The concept of strategy. Strategy is the creation of a unique and valuable position, involving a different set of activities.

The concept of competitive advantage. Competition is at the core of the success or failure of firms. It determines the appropriateness of a firm’s activities that can contribute to its performance, such as innovations, a cohesive culture or good implementation.

The concept of competitive strategy. Competitive strategy is about being different. It can be defined as choosing a different set of activities to deliver a unique mix of value.

Competitive strategy is the search for a favourable competitive position in an industry, the fundamental arena in which competition occurs. Competitive strategy aims to establish a profitable and sustainable position against the forces that determine industry competition. Competition is multidimensional and strategy is about making choices in many dimensions, not just one. No single prescription about which choices to make is valid for every company in every industry.

The concept of value chain. In his book Competitive Advantage, Professor Porter introduces the concept of a value chain as a general framework for thinking strategically about the activities involved in any business and assessing their relative cost and role in differentiation. The idea of the value chain is based on the process view of organizations, the idea of seeing a manufacturing (or service) organization as a system made up of subsystems each with inputs, transformation processes and outputs. These inputs, transformation processes and outputs involve the acquisition and consumption of resources – money, labour, materials, equipment, buildings, land, administration and management. How value chain activities are carried out determines costs and affects profits.

3. Performing a VCA in a Transfer Pricing Context

The concept of a VCA for transfer pricing purposes.

The VCA is an analytical system designed to break down the different functions of a company and examine the costs. In a transfer pricing context, it also defines the activities within the supply chain that create a competitive advantage over competitors.

The core question for the performance of a VCA in a transfer pricing context is: why is the company profitable and/or why is the company more profitable than other companies? When comparing a company with its competitors, the financial analysis and benchmarking process is essential. Analysing the existence of a competitive advantage allows you to follow the precise link between the value you create, how you create it (the value chain) and how you perform (the profit-and-loss account, P&L).

A competitive advantage exists if the company’s return on capital invested (ROCI) profit level indicator is above the average of that of comparable companies. This aspect will be explored further in the description of the six steps to perform a VCA (see section 4).

Any company that manages to survive in a specific market in an independent manner manages to do so by its strong position compared to competitors. In the case of routine companies, that favourable position would mean that although they are doing something right to survive in the market, it is not necessarily something different that is setting them above their competitors. Routine companies, for example, intend to survive and be profitable, but their level of value creation is different than, for example, that of a manufacturing company or an entrepreneur.

The question for transfer pricing purposes would be: which activities are creating that favourable position in the case of routine and non-routine companies? What is every single subject within the supply chain doing from a strategy perspective that contributes to the value creation of the group?

With the purpose of achieving a VCA that can be read together with a transfer pricing policy, this analysis will identify the functions a company performs to maintain a favourable position within its industry.

The following simplified five-step analysis takes into account Professor Porter’s frameworks for the first part and further development of his model for transfer pricing purposes.

4. The Five Steps of a VCA for Transfer Pricing Purposes

The VCA has similarities with a comparability analysis but the latter analysis is performed to analyse one transaction between related parties and its comparison to an uncontrolled transaction. The VCA, on the other hand, has the purpose of defining competitive strategies from

5. Id.
7. Id.
9. Supra n. 5, at 33.
11. Supra n. 9, at 9.
an overall perspective. The goal of any strategy will be to attain superior profitability.

The five steps that are proposed for a VCA are:
– analysing the industry;
– analysing the company;
– mapping the value chain and its core drivers;
– drawing the value chain; and
– feedback.

4.1. Analysing the industry

The essence of formulating a competitive strategy is to relate a company to its environment. Analysing the industry is also very important because every industry has a different potential. The first step of an industry analysis is the description of the product or service and its regional or geographic scope.

Within the industries, different external forces come into play. Porter identified five relevant forces that will have different strengths depending on the industry. Porter’s five forces are:
– suppliers: bargaining power of suppliers;
– potential entrants: threat of new entrants;
– buyers: bargaining power of buyers;
– substitutes: threat of substitute products or services; and
– rivalry among existing competitors (firms).

For some industries, raw material or material suppliers play a substantial role. Usually, product manufacturing companies will depend on the suppliers and they can have a very large impact on the profitability of a company by imposing their own conditions (in terms of cost or quality).

In some cases, regulatory aspects and the geographical location of the raw material providers will also affect their relevance within the supply chain. The influence of suppliers will depend on their own competitive status, whether they are operating in a particularly tight situation or under monopoly circumstances, whether they supply to one or more industries, etc. Other factors can be the high transfer of costs, suppliers offering specific products that have no substitutes and suppliers being able to incorporate more activities into their core business further down the supply chain.\(^{14}\)

New entrants exert influence on the market by reaching previously unoccupied positions and by delivering greater value to new customers. The possibility of winning new market share increases the pressure on prices and policies on cost and investment rates. The threat of new entrants is stronger when there is no patent to protect technologies (which allows easy access to such technologies), when barriers to entry into the market and the capital requirements are very low, when replacement costs for the customer are low and when the government provides aid and subsidies to new entrants.\(^{15}\)

Substitute products or services offer alternatives to the existing industrial sector. They respond to customer needs in a different or innovative way. They become real threats when the offer constitutes better quality, when the cost of transferring to the substitute product is low and when the price of the product is lower. Another factor for the company to consider while analysing the substitute force is that when other products appear on the market, they pose a threat by gaining an existing market share and putting pressure on prices.\(^{16}\)

The influence of customers in a competitive environment depends on their ability to negotiate. This can actually force companies to lower their prices and provide greater quality or additional services. Customers have even greater influence if they are small in number or purchase large volumes, when the products or services available on the market are standardized and differ very little from competing products or services, when the transfer of cost from one supplier to another is low and when they can directly integrate the suppliers’ activities into their production chain.\(^{17}\)

Rivalry among existing firms is at the heart of the model. The rivalry of the sector can be influenced and evaluated by the other forces of the model. Competitors are constantly striving to improve or simply maintain their position in this field. Internal competition can take many forms and results in different actions.\(^{18}\)

For transfer pricing purposes, every situation is different because it consists of different individuals, circumstances, services or products and markets. Analysing the five forces will allow the reader to understand a company’s position and the importance of a specific value chain strategy within that specific industry because the five forces

\(^{12}\) Supra n. 5.

\(^{13}\) Id.

\(^{14}\) S. Michaux & A.-C. Cadiat, Porter’s Five Forces (Management & Marketing 50 min), at 8.

\(^{15}\) Id., at 9.

\(^{16}\) Id.

\(^{17}\) Supra n. 15, at 8.

\(^{18}\) Id., at 11.
affected the cost prices and investment that a company will need in order to be successful.

Business competition is complex and it has become more open-ended and multidimensional. Within an industry, several contests may be taking place, rather than just one, based on which customers and needs have to be served.\(^{19}\)

Having followed this step, the MNE should be able to determine how it positions itself in relation to its competitors, to the industry and relative to the five forces.\(^{20}\)

4.2. Analysing the company

Once the industry has been analysed, analysing the company is a matter of placing the MNE within that industry in terms of market share, competition, history, diversification, etc. At this stage, a strengths, weaknesses, opportunities and threats (SWOT) analysis is appropriate, since the purpose of this section is to analyse the company from an internal perspective. The SWOT analysis allows organizations to identify their internal factors.

Strengths are those internal factors that help the company to hold a competitive position within the industry. Weaknesses, contrary to strengths, undermine the competitive position of the organization. Opportunities and threats are linked to external factors that influence the competitive position of the organization in a positive and negative way, respectively.

In this step of the process, the size of the company, the open possibilities of expansion and M&A strategies are also relevant. This section will introduce the reader to the value chain and it should also describe, for example, the cost-saving strategies, key performance indicators (KPIs) in place, restrictive policies and corporate governance, always seen from a group perspective.

At the end of this step, the company should have established whether it possesses a competitive advantage. If the company possesses such an advantage, it will be operating at a lower cost; can demand a premium price, or both. There will be superior performance in relation to its rivals. Usually, the financial measure used to analyse whether a company operates as an average player within an industry or whether it really possesses an advantage, is the return on invested capital (ROIC). The ROIC represents the financial measure used to analyse whether a company operates as an average player within an industry or whether it really possesses an advantage, is the return on invested capital (ROIC). The ROIC represents

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\text{ROIC} = \frac{\text{net income} - \text{dividends}}{\text{total capital}}
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4.3. Mapping the value chain and its core drivers

The value chain consists of a series of actions based on sustainable economic approach that is designed to establish and enhance a successful product or service in the market.\(^{21}\)

According to Porter, the value chain can be divided into primary and support activities. The primary activities will affect the added value of the final product. The support activities will be indirectly involved in creating the final added value. Which activities are primary and which are secondary will depend on the industry and company. For example, a service provider will never have those activities that might be primary activities for a product manufacturing company.

The purpose of this step is to map the company supply chain and its core drivers. A supply chain is understood to mean a general framework for thinking strategically about the activities involved in any business and assessing their relative cost and role in differentiation.

Companies should start with describing the supply chain. The MNE will describe the sequence of activities of the group that are performed to design, manufacture or produce, market, sell, deliver and support its products or services. The biggest challenge in some cases is where a company has different supply chains depending on products, business units or segments. In this case, it is wise to keep the focus on the overall supply chain, the main supply chain, since the goal of this step is to identify the value creation activities for the group as a whole.

First, take as a reference point your suppliers, channels and customers. Draw your primary activities and support activities. For example, in the case of a manufacturing group, the industry analysis would reveal that this hypothetical company manufactures high-tech products in an environment or industry where innovation technology and quality are key factors for success. Raw materials are not substitutable and are restricted in some regions.

The first description or mapping of the supply chain is shown in Figure 3. This would be the general process the majority of the products go through. The example in Figure 2 shows a traditional supply chain:

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19. Supra n. 9, at 22.
20. The five forces are not limited. The taxpayer can take them as a basis and include the specific forces that come into play for its industry. Although Porter’s model should cover the basis for the analysis, there is room for additional information.
21. X. Robben, Michael Porter’s Value Chain, unlock your company’s competitive advantage (Business Management 50 min), at 2.
The secondary activities are shown in Figure 3.

In a second step, you will want to link this graphic to the points of connection, costs, price and value drivers.

The value chain is a powerful tool for disaggregating a company into its strategically relevant activities in order to focus on the sources of competitive advantage, that is, the specific activities that result in higher prices or lower costs. See Figure 4.  

The description of routine companies is also essential for the VCA since the differentiation between routine and main activities or relevant activities will allow the reader to classify certain activities as less relevant from an overall perspective.

As a conclusion of this section, the main questions that should be answered are: what are the SWOTs of the group, the channels and points of connection? What does the global supply chain look like? What factors affect the cost and price of the product or service? What are the main value drivers?

Common mistakes while performing a VCA include:
- not including all steps in the value chain;
- imprecisions when identifying the scope of the value chain; and
- distortions in the value chain diagram.

A more decentralized value chain would look different to the one in the example above, see Figure 5. 

4.4. Drawing the value chain

At this stage, the chart presented as Figure 4 or 5 can easily be completed by determining first which legal entities perform which functions within the supply chain and, second, where the strategy is defined within those legal entities. For that last step, the person performing the VCA has to know who is taking the strategy decisions. This decision will represent the path the company wants to follow and the trade-offs it is willing to make. Through the process, you should start seeing the activities not only

22. Supra n. 9, at 75.

23. Based on the model supra n. 22, at 18.
as a cost but as a step in the value creation. Questions to be asked are: which legal entities have a “core competence”? What is different from their competitors?

Probably one of the most complicated aspects of an analysis such as the one presented in this article is to get the facts right. Therefore, after this very significant exercise, the last step is fundamental. It is important to obtain feedback, which should confirm that the information makes sense, not only to the person that performed the analysis but also to those who have a general perspective of the group.

4.5. Feedback

Although this is the last step of the VCA, it is extremely important to receive feedback during all steps of the exercise. People express their point of view not just in different ways but also for different reasons. Therefore, talking to a select group of people within the MNE will only provide a selective point of view.

The more feedback you receive, the better the process and the sooner the feedback is available, the better. Having this aspect at the end is useful because there should be a sanity check before finishing the exercise. Who the key people are to talk to, will depend on the type of company. For example, in the case of the manufacturing entity, the key areas are R&D, logistics, marketing and sales and quality management.

5. Conclusions

Performing the five steps of the VCA for transfer pricing purposes will allow the reader to understand the company’s position within an industry, the external and internal factors affecting its performance, the nature of the supply chain and, most importantly, what each legal entity within the group is doing that creates value for that company in that industry. With a clear VCA analysis, the transfer pricing policy can be aligned with the company strategy. Understanding the VCA will also facilitate the planning and reviewing of transactional transfer pricing policies. At the end of the exercise, the reader will know if there is any strategy in place to create a competitive advantage and whether the strategy and the transfer pricing policies together make sense, as well as whether processes are aligned with the value creation.

Last but not least, the challenge for the tax administration will be the protection of information included in such analysis. Are they ready?