Segmentation of financial data: rarely used defence in transfer pricing (2/34/20)

Before the transfer pricing rules were amended, only a few taxpayers were aware of the significance of financial data segmentation. Once amendments to section 15.[2] of the Taxes and Duties Act came into force, preparing financial data segmentation can no longer be seen as a voluntary exercise because from 2018 its inclusion in the transfer pricing documentation is a statutory requirement taxpayers must meet to avoid penalties.

Statutory requirements

Under paragraph 3.3.2 of the Cabinet of Ministers' Rule No. 802, a taxpayer preparing the so-called local file is required to include financial information and tables showing how the financial data used in applying the transfer pricing method is linked to the taxpayer's financial statements. The OECD transfer pricing guidelines also provide that in arriving at the net profit indicator, only items that are closely linked to the controlled transaction, whether directly or indirectly, and also linked to the business activity should be taken into account, but any costs and revenues that are not linked to the controlled transaction can be ignored if they materially affect comparability.

In a comparability analysis, arm's length range indicators should be compared with the company's relevant profit level indicator gained/achieved in the controlled transaction, rather than with the company's total profit level, which is measured by using all the financial data included in its profit and loss account (P&L).

For a better understanding, let us look at a practical example that will help us identify risks caused by the absence of financial data segmentation and evaluate its significance when preparing it.

Practical example

X Ltd is a Latvian-resident company that manufactures wooden tables. In 2019, the company entered into transactions with related and unrelated companies, and sold its finished goods to third parties on the Latvian market and to related foreign companies abroad.

In 2019, the company invested significant funds and resources in winning a new customer, which led to a large order. The company did not have the capacity to fulfil its existing orders and therefore acquired substantial assets (manufacturing equipment) and made a strategic decision to move its manufacturing to larger premises.

Due to relocation, the company temporarily hired employees to help move to the new premises quickly and efficiently. It is important to note that the company had some downtime during the relocation because the equipment was not used for a while.

All of these factors affected the company's financial performance for 2019. The table below shows its P&L for 2019 (unsegmented financials):

Indicator	**2019 (EUR)**
Net revenue	10,000
Cost of goods sold, including:	9,400
Materials costs	*4,300*
Staff costs	*900*
Rent and utilities	*750*
Depreciation	*1,400*
Other costs	*2,050*
Gross profit	600
Selling costs, including:	500
Marketing costs	*300*
Administration costs	550
Total costs (1)	10,450
Profit or loss before taxes (2)	–450
Net margin (2/1x100)	*–4.31%*

Observations

- A third party that examines the financials for the entire company without going into business details may get the impression that the related-party transactions have contributed to the loss for 2019.
- We have seen in practice that the State Revenue Service ("SRS") views losses as a risk inherent in related-party transactions.

Financial data segmentation

After evaluating the company's business description and the factors affecting its financial performance, as well as conducting an analysis of the functions performed, a financial data segmentation was carried out.

We recommend doing a financial data segmentation early and ensuring that the transfer pricing documentation describes in detail the reasons and circumstances that caused the loss.

The table below shows segmented financials of the P&L for 2019:

Indicator	**2019 (EUR)**	**Transactions with unrelated parties**	**Transactions with related foreign companies**	**One-off costs with no profit element**
Net revenue	10,000	7,200	2,800	-
Cost of goods sold, including:	9,400	5,900	2,355	1,145
Materials costs	*4,300*	*3,000*	*1,300*	-
Staff costs	*900*	*500*	*150*	*250*
Rent and utilities	*750*	*450*	*170*	*130*
Depreciation	*1,400*	*650*	*400*	*350*
Other costs	*2,050*	*1,300*	*335*	*415*
Gross profit	600	1,300	445	-
Selling costs, including:	500	475	25	-
Marketing costs	*300*	*300*	-	-
Administration costs	550	400	150	-
Total costs (1)	10,450	6,775	2,530	1,145
Profit or loss before taxes (2)	–450	425	270	–1,145
Net margin (2/1x100)	*–4.31%*	*6.27%*	*10.67%*	-

Observations

- The company highlighted three segments reflecting its performance.
- One of the segments is “One-off costs with no profit element.” These one-off costs arose from the strategic decision to move to larger premises in order to use the equipment at full capacity. However, considering the downtime, equipment depreciation during the downtime (relocation), extra wages and other costs, the company classified them as one-off relocation costs with no profit element. These costs cannot be allocated to any other segment and should therefore be separated out.
- The result of the “Transactions with unrelated parties” segment is different from the result of the “Transactions with related foreign companies” segment. This difference was driven by a number of factors:
  - Winning a new unrelated customer – high marketing costs;
  - A large order from the new customer – the new equipment purchase leading to substantial depreciation charges;
  - According to time sheets, the staff spent a long time learning how to operate the new equipment.
- The result of the “Transactions with related foreign companies” segment shows that the company’s related-party transactions did not affect the loss. This means that the price charged in the 2019 transactions with related foreign companies is arm’s length.
- Credible and valid financial data explains what caused the loss for the financial year. The financial data segmentation helped the company identify its loss-making segment.

Conclusions

Financial data segmentation provides useful information for comparability analysis and clearly details the actual business results, helping the taxpayer to prove key aspects that a third party (including the SRS) may have difficulty noticing and understanding when conducting a general assessment and analysis of the taxpayer’s financials.