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Credit rating model in transfer pricing analysis 2/22/21

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When doing a transfer pricing analysis of financial transactions, we need to assess the borrower's creditworthiness before setting an interest rate. To evaluate the risk associated with an intragroup financial transaction and determine an arm's length interest rate for taking credit risk, the lender should evaluate the likelihood of the borrower defaulting, i.e. creditworthiness, and the probability of recovering the loan. This article explores a credit rating model that multinational enterprises often create to determine the creditworthiness of particular units.

Assigning a credit rating

If the borrower does not have a publicly available credit rating assigned by an independent credit rating agency, then we can use commercially available credit rating tools and methodologies offered by credit rating agencies and financial service providers to determine the borrower's creditworthiness. Based on publicly available methodologies, companies can devise a credit rating model, which is a useful tool for correctly setting an arm's length price in related-party transactions.

In practice the credit rating methodologies published by Moody's are commonly used because they contain a detailed description of the credit rating steps and are available on Moody's website free of charge.

The publicly available credit rating methodologies are mainly based on the information presented in the financial statements (quantitative criteria), yet qualitative criteria are often evaluated in addition. Also, each qualitative and quantitative rating criterion is made from special subfactors that are used to quantitatively assess the main rating criteria and compute a particular unit's creditworthiness on their basis.

Quantitative risk analysis

Quantitative analysis is based on the borrower's financial data. This involves evaluating the company's financial position by examining items on the balance sheet, the profit and loss account and the cash flow statement and giving a score to each subfactor of the credit rating criterion, to be taken into account when determining the borrower's creditworthiness. In practice common quantitative indicators are the borrower's revenue, profitability (operating margin) and financial flexibility indicators such as total liabilities to EBITDA.

Before a credit rating can be assigned, we need to evaluate what data is available and can be used in the calculation. A credit rating can be computed using the borrower's (1) historical financial results for the previous fiscal year or (2) the forecast financial results for the current or the next fiscal year.

When it comes to determining the borrower's ability to repay the funds, it is important to evaluate his future financial prospects. We wish to emphasise that historical financial data does not reflect how the borrower's financial position is going to change, including cash flows, after the new financing is received and absorbed. Interest charged on a made loan should affect the borrower's financial position, so it is advisable to include the new financial transaction in the calculations in order to better evaluate the borrower's creditworthiness as soon as a new loan is made.

For the reasons described above, using forecast financial data provides higher accuracy, so it is advisable to use forecast financial data for the credit rating analysis. Data for the previous fiscal year is better used where forecasts for the current or the next fiscal year are not available or cannot be reliably determined, for instance, because of unpredictable market conditions or demand for goods or services.

Qualitative risk analysis

Qualitative analysis is based on a subjective evaluation of different business processes in a particular unit. The outcome of the subjective evaluation can vary according to the person or persons doing the analysis and the persons being interviewed. Rating agencies such as Standard & Poor's and Moody's carry out a qualitative analysis by interviewing the company's management and key employees. These interviews help the agencies carry out an analysis of strengths, weaknesses, opportunities and threats, which allows them to evaluate the organisation's strategic movement and ability to adapt in an ever changing environment.

Qualitative analysis is carried out in a similar way, also based on publicly available methodologies where the borrower's management and key employees evaluate business processes and answer various questions. For example, a common subfactor criterion in the qualitative analysis is the demand subfactor, which includes several questions about the need for goods or services, including stability of the demand, diversity of goods/services on offer, and their significance to customers. In the credit rating model, when determining the description of demand for services that best fits the borrower, a particular subfactor credit rating will be applied, to be taken into account when determining the borrower's overall credit rating. Other commonly used subfactors in the qualitative analysis are the borrower's financial policy and competitive profile.

Advantages of the credit rating model

The credit rating model mainly prevents unnecessary discussions between group companies if this is used and included in the group's overall transfer pricing policy. This model also allows you to automate and thus minimise the margin of error in the group's transfer pricing, as well as easing the administrative and financial burden in terms of preparing the transfer pricing documentation.

And last but not least – the credit rating model is based on market practice. This ensures that the transfer prices are arm's length and consistent with the recommendations included in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations of July 2017.

Setting up the model ensures it is carried out in real time and makes it possible to frequently update variable interest rates between group companies without an excessive consumption of resources. If you would like to discuss the credit rating model in detail or need support in doing a transfer pricing risk analysis and/or drawing up a transfer pricing policy, please reach out to PwC's transfer pricing team.