AUDITING MULTINATIONAL ENTERPRISES

CUTTING EDGE EXAMPLE

1. Introducing Cutting Edge 2009 Accounts

TRANSFER PRICING METHODS EXAMPLE - CUTTING EDGE CORPORATION

Key facts

- Cutting Edge Corporation (CE Corporation) manufactures and sells advanced and specialised electronic equipment used in diagnostic testing in hospitals.
- The parent company, CE Corporation is resident in Country A, where it has an R&D facility, a manufacturing facility and a domestic sales division.
- It has one subsidiary, CE (B) Ltd, resident in Country B, which carries out a sales/distribution function.

Tasks

Assume you are the auditor in Country A of CE Corporation. You are provided with the 2009 accounts of CE Corporation and CE (B) Ltd.

a. What do you think is likely to be the main international tax risk?
b. What further information might you ask for at this stage?

Cutting Edge Corporation: Extracts from accounts 2009 (non-consolidated)

Profit and loss account, $m (summary)

Turnover	95
Cost of goods sold	50
Gross profit	45
R&D expenses	15
Sales and marketing	7
Other general and admin	4
Operating profit	19
Dividends received	4
Pre-tax profit	23
Tax payable	6.9

Extracts from balance sheet at 31st December 2009

Inventory	9
Trade debtors	10
Trade creditors	5
Investments in subsidiary	5

The company is described in the accounts as a developer and manufacturer of advanced medical diagnostic equipment.

Extracts from Accounts of Cutting Edge (B) Ltd, 2009

Profit and loss summary

Turnover	100
Cost of goods sold	75
Gross profit	25
Sales expenses	10
General and administrative expenses	5
Operating profit	10
Tax	3.5

The accounts describe Cutting Edge (B) as a distributor of electronic equipment used by the medical profession.

AUDITING MULTINATIONAL ENTERPRISES

CUTTING EDGE EXAMPLE

2. Further information - letter from the Cutting Edge Corporation

As a result of your initial review of the 2009 Cutting Edge group accounts, you identified the transfer pricing between Cutting Edge Corporation and Cutting Edge (B) as a key risk. You wrote to the company, asking for further information

Your letter to the company, and the company's reply, is below.

Task

On the basis of the company's reply, would you accept that the transfer pricing of goods between Cutting Edge Corporation and Cutting Edge (B) is satisfactory? Why?

CUTTING EDGE CORPORATION – LETTER TO COMPANY

Dear Sir

Cutting Edge Corporation Ltd – 2009 Accounts

I have reviewed the 2009 accounts for Cutting Edge Corporation.

I would like to understand the extent and nature of any transactions between Cutting Edge Corporation and Cutting Edge (B) and ask you to provide me with the following information.

1. Details of the nature and quantum of sales between Cutting Edge Corporation and Cutting Edge (B).
2. How the pricing of those sales is set.
3. Details of work carried out to establish that the prices are arm's length, including transfer pricing documentation maintained for that purpose
4. A description of the main functions carried out by Cutting Edge Corporation and Cutting Edge (B).
5. A description of any other transactions between Cutting Edge Corporation and Cutting Edge (B) that falls within the scope of the Country A transfer pricing rules.

Please provide this information within 21 days of the date of this letter. Please advise me if it is not possible to meet this timescale.

Yours faithfully

Mrs N. Merchant
Country A Tax Audit Department

CUTTING EDGE CORPORATION – LETTER FROM COMPANY

Dear Sir

Cutting Edge Corporation Ltd

Thank you for your letter of 26th March 2011. I answer your questions as follows.

1. As you are aware, the Cutting Edge group develops, manufactures and sells electronic equipment for use by the medical profession. Units are manufactured at the Cutting Edge Corporation plant here in Country A and are then sold by Cutting Edge Corporation in A or by Cutting Edge (B) Ltd in B. Our total domestic sales in 2009 were $30m and our sales to Cutting Edge (B) Ltd were $65m.
2. Pricing is set by negotiation between the management of Cutting Edge Corporation and the management of Cutting Edge (B) Ltd. These are real negotiations that result in a fair price for the units.
3. We do not maintain any specific transfer pricing documentation but, as I mentioned, the pricing between Cutting Edge Corporation and Cutting Edge (B) Ltd is clearly "arm's length". It is arrived at by a process of negotiation and reviewed by our management. You will see that Cutting Edge Corporation is very profitable and pays a high level of tax in Country A. Also, the profit of Cutting Edge (B) is certainly not excessive, and significantly less than Cutting Edge Corporation.
4. Cutting Edge Corporation is a privately owned company that has developed a small range of specialised and advanced electronic equipment used by doctors in larger practices and in hospitals. This equipment is manufactured by Cutting Edge Corporation and then sold either in Country A or, through Cutting Edge (B) Ltd, in Country B.
   Cutting Edge (B) has a specialised sales-force (some of whom are retired doctors) which sells units to the medical profession and hospitals in Country B. It also sells some units manufactured by IndyMedical Ltd, a small and specialised company based here in Country A.
5. Apart from payment for the sale of units, no other payments are made between Cutting Edge Corporation and Cutting Edge (B).

I trust this satisfies your concerns.

Yours Faithfully

Pete Timmins
Finance Director

AUDITING MULTINATIONAL ENTERPRISES

CUTTING EDGE EXAMPLE

3. Cutting Edge Group – information for choice of method and comparability analysis

As a result of your initial review into the transfer pricing between Cutting Edge Corporation and Cutting Edge (B), you decide to test the pricing to assess whether it meets the arm's length standard.

You ask for further details of pricing and you hold a fact-finding meeting with the Finance Director, Mr Pete Timmins.

- Section A below contains the notes of your meeting with Mr Timmins.
- The information you receive on pricing is summarised at Section B below.
- Section C provides an extract from the accounts of IndyMedical

You are asked to:

Assess the availability and reliability in this case of:

- A comparable uncontrolled price method
- A cost-plus method
- A resale-price method
- A transactional net margin method.

A Notes of Interview with Pete Timmins, Finance Director, Cutting Edge Corporation

We spoke with Mr Timmins in his office on 3rd May 2011. Mr Timmins provided the following information:

1. It was confirmed that Cutting Edge is a privately owned group of companies that had been established for about 15 years. The company specialised in the manufacture of specialised electronic equipment used by doctors for diagnosis. Its main product is an electronic monitor used by doctors to assess the state of patients' circulatory system.
2. The products have been developed in Cutting Edge Corporation which has a highly regarded research and development team. The designs are patented in all the main countries in the region.
3. Sales have been strong in recent years and forecasts are good. This is partly because the products have advanced specifications and have a strong reputation for reliability. Also, the market for this type of equipment in the region has been growing with the steep increase in healthcare provision – including a certain amount of "health tourism" into the region.
4. The company's manufacturing processes are regarded as one of the most advanced in the industry.
5. All sales are made by either Cutting Edge Corporation or Cutting Edge (B) - the latter in Country B, where there is a large and increasingly important healthcare sector. All products carry the Cutting Edge brand, which is registered in all the main countries of the region under the name of Cutting Edge Corporation.
6. Cutting Edge (B) purchases units from Cutting Edge Corporation for sale to third party customers – mostly hospitals – in their respective markets. They take delivery of machines, check that they are fully functional and deliver them to customers. Their sales forces are relatively highly skilled –which is important because they need to understand the technical capabilities of the units and the requirements of doctors. They carry out demonstrations both during the sales process and when they are delivered following a sale. They also negotiate sales prices and are able to agree a discount to the list price – or preferential terms on after-sales service - if needed. However, these discounts have to be met by Cutting Edge (B) – they cannot be passed on to Cutting Edge Corporation.
7. If machines are faulty on purchase or within the first year, they are returned to Cutting Edge Corporation who will provide a replacement. If they become faulty after that period, repair is at the expense of the customer, as is routine servicing. Cutting Edge (B) provides product repair and servicing facilities to their customers, who are charged for this.
8. Cutting Edge (B) does not keep a stock of products and their stock is mostly spare parts used in servicing and repair. It is only when they receive a firm order for units from a customer that they transmit an order to Cutting Edge Corporation - and delivery is normally made within a few days.
9. Cutting Edge (B) does not carry out any research or development work, although they do monitor the state of their respective markets and feed this back to Cutting Edge Corporation. Customers sometimes look for specific

modifications – in which case the Cutting Edge B sales personnel will refer to the R&D department of Cutting Edge Corporation to develop and test the required modifications.

10. Cutting Edge (B) also distributes units manufactured by (and purchased from) IndyMedical Ltd, an independent manufacturer of medical devices. These units are not as advanced as those manufactured by Cutting Edge Corporation and sell at a lower price ($108K on average, rather than $132K). They are also sold to hospitals and some doctors – some of whom have used the IndyMedical product for some years and have a preference for it. They are sold under the IndyMedical brand and carry the IndyMedical logo.
11. We asked about the terms of purchase from IndyMedical and Mr Timmins said it was much the same as those with group products, except that IndyMedical replaced faulty products up to two years after delivery rather than one year.
12. Cutting Edge (B) agrees credit terms with customers and takes the risk of any bad debts.
13. Cutting Edge (B) also carries out extensive marketing for both IndyMedical products as well as Cutting Edge products – largely by setting up stalls at, and sponsoring, conferences and exhibitions.
14. We also asked Mr Timmins if any services are provided by Cutting Edge Corporation to Cutting Edge (B). Mr Timmins said that no other payments are made. We explained that that does not necessarily mean that no services are in reality provided. On reflection, Mr Timmins thought that little was provided by Cutting Edge Corporation – the largest item being staff technical training - which was provided by both Cutting Edge (Manufacture) and IndyMedical on their respective machines.

B. **Pricing Information**

1. During 2009, Cutting Edge Corporation sold 650 units to Cutting Edge (B) at an average price of $ 100 000 each (a total of $65m).
2. The average sale price of these units by Cutting Edge (B) to third party customers in Country B was $132 000.
3. During the same period, Cutting Edge (B) purchased 125 units from IndyMedical at an average price of $80K (a total of $10m).
4. The average sale price of these units to third party customers in Country B was $108K.
5. In 2009, Cutting Edge Corporation sold 225 units in Country A at an average price of $ 133 000 each (a total of $30m).

C. Extracts from the 2009 accounts of IndyMedical. Extracts are shown below.

Extracts from Accounts of Independent Manufacturer (Country A) 2007

Profit and loss summary

Turnover	200	
Cost of goods sold	120	
Gross profit	80	
Mark-up on costs		*66.7%*
Overheads	65	
Operating profit	15	
Operating profit rate		*7.5%*

AUDITING MULTINATIONAL ENTERPRISES

CUTTING EDGE EXAMPLE

Comparability analysis between:
a) purchases of units by CE(B) from CE Corporation, and
b) purchases of units by CE(B) from IndyMedical.

(For use in Stage 3)

	Units sourced from Cutting Edge Corporation	**Units sourced from IndyMedical**	**Comparable?**
Nature of product			
Type of product			
Sales price			
Sales volume			
Market			
Geographical market			
Level of market			
Functions			
Sales - who performs?			
Price Negotiation – who performs?			
Warehousing?			
Distribution - who performs?			
After sales service – who performs?			
Risks			
Marketing and advertising			
Market risk – who takes the risk of decreases in prices or sales volume?			
R&D – who meets the costs?			
Inventory risk – who bears?			
Credit risk – who bears?			
Warranty risk – who bears?			
Assets			
Product intangibles – who owns?			
Marketing intangibles - such as trademark, brand etc. Who owns?			

AUDITING MULTINATIONAL ENTERPRISES

CUTTING EDGE EXAMPLE

Comparability analysis between:
a) purchases of units by CE(B) from CE Corporation, and
b) purchases of units by CE(B) from IndyMedical.

(For use in Stage 3)

	Units sourced from Cutting Edge Corporation	**Units sourced from IndyMedical**	**Comparable?**
Nature of product			
Type of product	Diagnostic units	Diagnostic units – less advanced	No
Sales price	$ 132K	$ 108K	No
Sales volume	650 units	125 units	Unlikley
Market			
Geographical market	Country B	Country B	Yes
Level of market	To sales/distributor	To Sales/Distributor	Yes
Functions			
Sales - who performs?	CE (B)	CE (B)	Yes
Price Negotiation – who performs?	CE (B)	CE (B)	Yes
Warehousing?	CE (B)	CE (B)	Yes
Distribution - who performs?	CE (B)	CE (B)	Yes
After sales service – who performs?	CE (B)	CE (B)	Yes
Risks			
Marketing and advertising	CE (B)	CE (B)	Yes
Market risk – who takes the risk of decreases in prices or sales volume?	CE (B)	CE (B)	Yes
R&D – who meets the costs?	Supplier	Supplier	Yes
Inventory risk – who bears?	Supplier	Supplier	Yes
Credit risk – who bears?	CE (B) - likely to be minimal	CE (B) - likely to be minimal	Yes
Warranty risk – who bears?	Supplier	Supplier	Yes
Assets			
Product intangibles – who owns?	Manufacturer	Manufacturer	Yes
Marketing intangibles - such as trademark, brand etc. Who owns?	Manufacturer	Manufacturer	Yes

AUDITING MULTINATIONAL ENTERPRISES

CUTTING EDGE EXAMPLE

4. Extracts from 2011 accounts

You are now provided with the 2011 accounts of Cutting Edge Corporation, which has been renamed Global Medical (A).

As you will see, Cutting Edge Corporation was acquired by another group – the Global Medical Group - on 1st January 2011 and, at that time, it was renamed Global Medical (A).

When you receive the 2011 accounts, you carry out some preliminary research into the acquisition.

You are provided with:

- An extract from the 2011 accounts, and the 2011 taxation computation, of Global Medical (A)
- An extract from article you found on the website of a trade journal for medical equipment.

You are asked to consider what issues you consider potentially significant and what further information you would seek at this stage.

Extract from 2011 Accounts of Global Medical (A) (Formerly Cutting Edge Corporation)

	($m)
Turnover	136
COGS	65
Gross profit	71
R&D	15
G&A	25
Advertising and marketing	10
Royalty	12
Operating profit	9
Other income	8
Interest	12
Net profit before tax	5

Extracts from Balance Sheet as at 31st December 2011

Inventory	10
Trade debtors	14
Investments in subsidiary	155
Trade creditors	20
Issued share capital	50
Bank loan	150

Extracts from Notes to the Accounts

On 1st January 2011, Global Medical (Holdings) SARL acquired all the issued share capital of Cutting Edge Corporation, and its name was changed to Global Medical (A).
During the year, Global Medical (A) purchased $100m 8% preference shares in GM Finance Ltd.
During the year, Global Medical (A) purchased $50m ordinary shares in GM Insurance (Cayman Islands)

Extracts from Income Tax computation of Global Medical (A), year to 31st December 2011.

Net profit before tax	$5m	
Less Dividends Received	$(8m)	
Taxable profit		$(3)m

EXTRACT FROM JANUARY 2011 ISSUE OF “MEDICAL TECHNOLOGY”

Almost before New Year celebrations had ended, we saw this year’s first major acquisition with the takeover of the Cutting Edge Group by South Africa based Global Medical. Most observers thought that it was question of when, not if, the fast expending Global Medical would enter South East Asia market. The acquisition of Cutting Edge group provides the answer - and gives Global Medical its much sought after foothold into the fast growing regional market.

Global Medical Chief Executive Matt Lockwood told us that he was “very excited by the prospect of entering South East Asia – an area of very fast growth in the medical diagnostic sector. Cutting Edge will provide us with a platform for the launch of some of our global products into the region.

Cutting Edge has built up a great reputation for developing highly innovative diagnostic equipment and we are particularly pleased that we can now incorporate this world class expertise into the Global Medical Group.”

Mr Lockwood said that there should be no fears about job losses – both the manufacturing and the research facilities in Country A will be maintained. In fact, it is expected that the R&D facility in Country A will become one of the Group’s core R&D centres.

Sector analysts considered Cutting Edge to be a very strong performer in this market. Historically, it has invested a great deal in developing innovative products built to very high standards. Analysts have considered for some time, however, Cutting Edge’s previous owners did not have financial capacity to allow it to take advantage of its technical excellence in the global market and, until now, its market was restricted to South East Asia. A real bonus for Global Medical is Cutting Edge’s R&D facility, considered to be one of the global centres of excellence on medical diagnostic technology.

AUDITING MULTINATIONAL ENTERPRISES

CUTTING EDGE EXAMPLE

5. Information regarding 2011 accounts of Global Medical (A)

Following your review of the 2011 accounts, you write to the company for further information and to arrange a meeting.

Specifically you ask for details of:

- the acquisition of the company
- the bank loan of $150m
- the acquisition of the preference shares in GM Finance Ltd
- general and administration expenses
- advertising and marketing expenditure
- royalty payments

You receive a reply to your letter and a meeting is arranged. You also receive the Company's transfer pricing report.

Tasks

You are provided with:

- A copy of a letter from the Global Medical (A) Finance Director (at A below)
- Notes from the subsequent meeting (at B below)
- Extracts from the transfer pricing report compiled by Global Medical's advisors, on the transfer pricing regarding services and R&D. (at C below)

You are asked to review this additional information and to consider:

a) which issues you think are important,
b) what further information you would seek
c) what next steps you would take.

LETTER FROM FINANCE DIRECTOR, GLOBAL MEDICAL (A)

Dear Sir

Thank you for your letter of 3rd March 2014.

1. As you know, Cutting Edge Corporation was acquired by the Global Medical Group on 1st January 2011. Global Medical is a group with headquarters in Pretoria, South Africa, involved in the development, manufacture and sale of medical equipment. It has expanded in recent years into the European and North American markets and has a 5-year growth plan under which it expects to expand into the SE Asia market. It sees the acquisition of the Cutting Edge group as a central component of its global growth strategy, and expects the acquisition of Cutting Edge to give it a platform for growth into the SE Asia markets. With the support and experience that the Global Medical group is able to provide, and access to Global Medical's other products, Global Medical (A)'s sales are expected to grow by around 50% in the next three years.
2. The acquisition was effected on 1st January 2011, when all the ordinary shares of Cutting Edge Corporation were sold to Global Medical Holdings (Luxembourg).
3. Global Medical (A) borrowed $150m from MoneyBank Ltd on 1st January 2011. The loan is repayable on 28th February 2016. The company pays an annual interest rate of 8%. The funds were used to acquire preference shares in a group company, GM Finance Ltd, resident in Genovia, and ordinary shares in GM Insurance (Cayman Islands).
4. The general and administration costs include:

   - salaries $10m
   - accommodation costs $2.5m
   - legal $3m
   - services $5m
   - others (including insurance etc) $4m

5. As far as service charges are concerned, the Head Office of Global Medical provides comprehensive and valuable services and support to all its subsidiaries. The service recharge is totally in accordance with the Group's global policy and is computed in the same way for all Group companies. I enclose a transfer pricing report which demonstrates the arm's length nature of the charge.
6. You will see that the transfer pricing report also demonstrates that the service fee received by Global Medical (A) for carrying out R&D services on behalf of Global Medical IP Holding Co is in accordance with the arm's length principle.
7. The advertising and marketing expenses during 2011 represented a renewed marketing campaign for the company's products and the costs of rebranding the company's products from "Cutting Edge" to "Global Medical".

8. The royalty is paid to Global Medical IP Holding Co. This is under a licence agreement which provides Global Medical (A) with valuable intangible property and support. In particular, it provides the company with exclusive use of the Global Medical name and trade marks in the SE Asia region, access to Global Medical's technical IP (including those relating to both product design and production processes), 24-hour technical support and technical training. The royalty is fully in line with group policy and is consistent with that paid by other Global Medical manufacturing entities in the group.

Yours

Pete Timmins
Finance Director

NOTES OF MEETING WITH PETER TIMMINS, FINANCE DIRECTOR, GLOBAL MEDICAL (A), 4TH May 2014

1. This meeting was held at our request in order to allow us to enquire into the Group's arrangements for intellectual property in particular.
2. We thanked Mr Timmins for his time and explained that the purpose of the meeting was solely fact-finding and that we did not intend to express a view at this stage about the acceptability to us of the arrangements.
3. He made the point that the takeover has had a very positive effect on the operations in Country A and the region. He said the financial backing and technical and marketing support that a global group like Global Medical can provide has enabled real growth, and increased employment, in the region. Country A's products will soon be manufactured and sold throughout the group. He said that, since the takeover, Global Medical (A) (formerly Cutting Edge Corporation) continued to produce much the same equipment as before, with relatively minor modifications and updates. Most sales were still to the subsidiary distribution company in Country B, but an increasing proportion is to group distributors outside the region. The biggest change has been in the volume of sales in Country B in particular, where the Group distribution company (formerly CE (B)) now sells and distributes other Global Medical products, in addition to the units manufactured by Global Medical (A).
4. Mr Timmins explained that the Global Medical Group has a policy of centralisation of ownership and management of all of the Group's intellectual property. This is achieved through GM IP Holdings. All Group IP is registered in the name of GM IP Holdings. For example, the GlobalMedical brand is registered in all countries in which Global Medical trades, and expects to trade, in the name of GM IP Holdings. Similarly, all trade intangibles are also registered in their name.
5. As far as marketing intangibles are concerned, when Cutting Edge was taken over by Global Medical, the Cutting Edge trademarks were transferred to GM IP Holdings. We asked what the latter paid for these. Mr Timmins replied that there was no price paid. It was not intended to use those TMs at all in the Global Medical group and all Global Medical (A) products have been marketed under the Global Medical brand since the takeover. They thus have no further value. They were transferred partly for good housekeeping, but also so that they can be monitored centrally to ensure that no competitors use or imitate them. From 1st January 2011, all sales in Country A and the region have been under the GlobalMedical brand. Mr Timmins said that this is a very well respected brand. Global (A) pays 10% royalty (on its own sales and to the group distributors) to GM IP Holdings.
6. In respect of trade intangibles, Mr Timmins said that Cutting Edge Corporations' existing intangibles (such as patent rights) were not

transferred to GM IP Holdings. This would have been difficult and, in any case, the expected life of these patents is not long. However, all future trade intangibles will be owned by, and registered in the name of, GM IP Holdings Ltd. He pointed out that GM IP Holdings funds all R&D activity throughout the Global Medical group, recompensing all R&D facilities their costs together with a mark-up of 5%. Thus, since 1st January 2011, GM IP Holdings have recompensed Global Medical (A) all its R&D costs (about $15m pa) plus a 5% mark-up. Mr Timmins pointed out that this was a very good deal for Country A – all R&D costs are recompensed and so the company takes no risk at all. Its costs are recompensed even if the R&D produces nothing of any value. He said the point at issue here, of course, is whether 5% was an adequate mark-up, but he thought the transfer pricing report adequately demonstrated this to be so – but he could provide further supporting material if we wished.

7. Mr Timmins informed us that GM IP Holdings is located in Genovia – ideally suited because of its central location. Whilst Genovia is a normal rate tax jurisdiction, he accepted that it has certain tax advantages – a good treaty network and generous amortisation of intellectual property – but insisted that it was located there for commercial reasons. He said that this is a real company (not a "brass plate") that properly managed all IP and that there were highly qualified personnel located there. In any case, it can be demonstrated that all transactions with GM IP Holdings are on arm's length terms.
8. We asked about the charge for head office services. Mr Timmins referred us to the transfer pricing report for further information, but stressed that the charge to Global Medical (A) was entirely in line with the charges to other group subsidiaries and in accordance with long established group policy.
9. He said that the transfer pricing report covered both the inwards R&D fee as well as the outwards service fee. In addition, it explained the arrangements for the royalty payments. We asked why it did not address the transfer price of goods produced by Global Medical (A) for sale to oversees distributors. He said that in 2011 the vast majority of such sales were to its own subsidiary distributor in Country B and that the arrangements had not changed since they were the subject of enquiry in 2009, when it was agreed they were at arm's length.
10. We asked Mr Timmins about the $ 100m purchase of preference shares in GM Finance Ltd (Genovia) and the purchase of $50m ordinary shares in GM Insurance (Cayman Islands). He believed that GM Finance is a group treasury company. GM Insurance is the Group's captive insurance company and the injection of equity into that company is to provide it with the necessary reserves to underwrite insurance policies for group companies. He believes those reserves are held in a third party bank.

AUDITING MULTINATIONAL ENTERPRISES

GLOBAL MEDICAL EXAMPLE

EXTRACTS FROM TRANSFER PRICING DOCUMENTATION YEAR ENDED 31ST DECEMBER 2011

Extracts from Transfer pricing Documentation – Global Medical (A), Year to 31st December 2011

Background

We were asked to review the transfer pricing of Global Medical (A) in relation to transactions undertaken with foreign affiliated parties during the year ended 31st December 2011.

We identified the following significant transactions in that year:

- The provision of research and development services by Global Medical (A) to GM IP Holdings Ltd,
- The provision of a variety of services by Global Medical Ltd to Global Medical (A).

We were also asked to consider whether there existed any transactions regarding intellectual property during the year. Our conclusions on this matter are described below.

Legislation

Country A introduced transfer pricing legislation in 2006. This legislation requires that, when a person conducts transactions with a related party in any tax year, the profit derived from that transaction, and returned in that person's tax return, is to be computed as though the transaction had been undertaken on arm's length conditions. That is, the conditions that would be found between unrelated persons.

Two persons are related persons if one controls the other or they are under common control. Control for these purposes includes where one person owns 50% or more of the ordinary share capital of the other.

Two persons are unrelated parties if they are not related, as defined above.

Country A's regulations specify that the arm's length principle as described above is to be applied in line with the OECD Transfer pricing Guidelines.

Functional analysis

a) Provision of research and development services

From 2011 onwards, Global Medical (A) provides research and development services to GM IP Holdings Ltd.

Global Medical (A) has extensive research and development facilities attached to its manufacturing plant located in Country A where medical monitoring units are produced. The research work carried out in this facility can be split into three broad categories:

- Developing modifications of existing models to meet specific customer requirements
- Updating and improving existing models
- Developing new generations of models
- Developing more efficient and reliable production processes

Much of the research and development effort is driven by market developments and requirements. It is the responsibility of GM IP Holdings to monitor such developments and, on the basis of this, to develop a research and development strategy and programme that meets market needs.

Our analysis shows that:

- GM IP Holdings develops a research and development strategy and engages Global Medical (A) to deliver this
- GM IP Holdings bears all the costs of research and development (through the payment of the R&D service fee to Global Medical (A)) and thus bears all the risk that arises.
- GM IP Holdings has ownership of any technical intellectual property that arises out of the R&D programme. This is consistent with GM IP Holdings intellectual property management role.
- Global Medical (A) bears no risks arising from the R&D programme and carries out a strategy developed, instigated and managed by GM IP Holdings.

Our conclusion is that Global Medical (A) should be characterised as a low risk service provider of R&D services.

b) Provision of Services

The Global Medical group has its headquarters in Pretoria, South Africa. This HQ provides a variety of valuable services that benefit all members of the group. In accordance with Group policy, and the transfer pricing rules of the countries concerned, the Group charges an arm’s length price to recipient companies throughout the group.

The services provided by HQ include the following:

- Provision of legal services, including a legal help-desk, which is able to provide advice on almost all legal matters. Under group policy, HQ review, and help draft if needed, all legal agreements entered into by or between group companies, including agreements with customers, contractors, employees and suppliers.

- Provision of IT services. HQ maintains the Group website and intranet, and assists with the purchase, setting up and maintenance of all the group IT systems. It also provides a 24-hr IT helpdesk for all group companies.

- Provision of HR services. HQ develops group-wide recruitment, employment and personnel policy and guidelines and assists with all personnel matters. They assist with the recruitment and placement of all top executives in the group.

- Strategy and management. HQ, including the group Board of Directors, sets the commercial strategy for the entire group. The expertise and experience of the Board in particular is considered to be one of the main factors behind the success of the group – something that provides a real benefit to all group members. In addition, HQ determines the group management policy and provides advice and guidelines on management to all group members.

Arm’s length price

a) ***Research and development services***.

In the light of the functional analysis described above, we consider that:

- It is not possible to find a comparable uncontrolled price for the R&D services that Global Medical (A) provides to Global Medical IP Holdings. This is because the former does not provide R&D services for independent parties and Global Medical IP holdings does not purchase R&D services from independent providers.

- As GM IP Holdings takes the entrepreneurial risks, and holds the relevant intellectual property, it would not be possible to identify reliable comparable information to enable us to benchmark an arm's length margin for the functions it carries out.

- Global Medical (A) carries out low-risk functions that do not employ valuable intellectual property and it is thus possible to identify reliable comparable information and to benchmark an arm's length return for the functions it carries out.

We conclude that the most appropriate transfer pricing method to determine an arm's length price for R&D services is the cost-plus method.

Comparable Searches - Contract R&D

Using a publicly available electronic database we conducted a search for companies in Country A that conducted research and development over the period 2009 -2011. We then:

- Excluded those companies which are members of groups
- Excluded companies that carried out functions other than R&D
- Excluded companies that our research showed hold valuable intangibles property,
- Excluded companies for which financial information was not available, or which were loss making over the period
- Excluded companies whose turnover was less than $5m

As a result of this process, we identified 6 companies in Country A that provided potential arm's length comparable data. [1]

The cost-plus mark up achieved by those companies (average pooled three year data) ranged from 0.9% to 6.6%, with an inter-quartile range of 2.6% to 5.9%[2]. We consider a cost mark-up of 5% represents an arm's length mark-up to Global Medical (A) for the contract R&D services it carries out.

b) Head Office Services

[1] In practice, transfer pricing reports normally include a detailed summary of the "search strategy" used to select potential comparables and summary financial information on the companies that are selected as potential comparables.

[2] The concept of an arm's length range is referred to in paragraph 1.45 of the OECD Transfer Pricing Guidelines. This is where the application of the transfer pricing method produces a range of figures all of which are equally relatively reliable.

In the light of the functional analysis described above, we consider that:

- It is not possible to find a comparable uncontrolled price for the HQ services that Global Medical HQ provides to Global Medical (A). This is because the former does not provide such services to independent parties and Global Medical (A) Holdings does not purchase such services from independent providers.

- Global Medical HQ carries out relatively low-risk functions that do not employ valuable intellectual property and it is thus possible to identify reliable comparable information and to benchmark an arm's length return for the functions it carries out.

We conclude that the most appropriate transfer pricing method to determine an arm's length price for HQ services is the cost-plus method and that the tested party should be Global Medical HQ.

Comparable Searches - Head Office Services

Using publicly available electronic databases we conducted a search for companies in Country A that carried out the following services over the period 2009 -2011:

- Legal services

- IT services

- HR services

- Management consultancy

. We then:

- Excluded those companies which are members of groups

- Excluded companies that carried out functions other than those above

- Excluded companies that our research showed hold valuable intangible property,

- Excluded companies for which financial information was not available, or which were loss making over the period

- Excluded companies whose turnover was less than $0.5 m

As a result of this process, we identified a number of companies in Country A that provided potential arm's length comparable data. [3] The results of this search for comparables are described below.

Search	Number of comparable companies identified	Interquartile range of full-cost mark-ups	Recommended mark-up
Legal Services	12	4.58 – 9.85	7.5%
IT Services	32	8.45 – 14.02	10%
HR Services	5	5.30 – 10.5	7.5%
Management consultancy	4	8.96 – 15.4	12%

The mark-ups specified above were applied to the full cost incurred by Global Medical HQ for providing the respective services. They were then divided amongst group member companies according to the following allocation keys:

- Legal services: turnover
- IT services: number of PC terminals and laptops
- HR services: number of employees
- Management consultancy: turnover

This resulted in payments by Global Medical (A) to HQ in 2011 as follows:

- Legal services: $800K
- IT services: number of PC terminals and laptops: $ 1.3m

[3] In practice, transfer pricing reports normally include a detailed summary of the "search strategy" used to select potential comparables and summary financial information on the companies that are selected as potential comparables.

- HR services: number of employees $ 900K
- Management consultancy $ 2m

Further analysis on intellectual property

We have been asked by Global Medical (A) to carry out an overview of its intellectual property and to ascertain whether there have been any transactions that fall within the scope of Country A’s transfer pricing rules.

The OECD transfer pricing guidelines identify two categories of Intellectual property: marketing intangibles and trade intangibles.

a) ***Marketing intangibles.*** These are concerned with marketing activities, which aid in the commercial exploitation of a product or service and/or has an important promotional value for the product.

i) *Global Medical Brand and Logos*.

Our analysis revealed that the Global Medical name and logo, which are registered trademarks in Country A and the surrounding region are marketing intangibles. These are registered in the name of GM IP holdings.

The Global Medical brand, TMs and logos are very well known and respected within the medical community. Our expectation is that units that carry such a brand would be able to be sold at a higher price, and in larger quantities, than units not carrying the brands. At arm’s length a royalty would be payable for the right to manufacture and sell products carrying the brand etc.

ii) *Cutting Edge brand, trademarks and logos*

On 1st January 2011, the registration of the CE brand and logo in countries A and B was transferred to GM IP Holdings.

We have considered whether this transfer represented a transfer of value. We have concluded that, at 1st January 2011, there was no value in the CE name and logo. The key reason for this is that, from 1st January 2011, the CE brand was no longer used by the group. It thus produced no income to any group member and had no value.

b) ***Trade Intangibles***. This category of intangible includes patents, designs and know-how.

i) *Global Medical Trade Intangibles.* All such intangibles are owned by GM IP Holdings, which also takes the entrepreneurial risk in developing them (through its management and funding of the group’s R&D programme).

Global Medical's products are considered to be high-tech and advanced products that display the very highest standards of reliability and design required by the medical industry. The associated intellectual property is thus very valuable and, at arm's length, a manufacturer/seller of such products would pay a royalty to the IP owner.

ii) Cutting Edge Trade Intangibles.

CE's products were generally considered to be technically advanced and, at 1st January 2011, there was one current patent and two designs registered in the name of Cutting Edge Manufacturing.

These intangibles, however, were not transferred to GM IP Holdings and existing patents and other trade intangibles have remained in the name of Global Medical (A).

All new registered patents and designs will, from 1st January 2009, be registered in the name of GM IP Holdings.

Determining an arm's length royalty for the use of GM IP Holding's intellectual property,

We have considered whether a Comparable Uncontrolled Price is available in respect of the intellectual property owned by GM IP Holdings. However, because of the unique nature of this intangible property, and the fact that GM IP Holdings does not licence any IP rights to independent third parties, it has not been possible to indentify a reliable CUP.

We have, however, searched a number of US databases and identified 12 licence agreements between independent parties which bear some similarity to the terms under which GM IP Holdings makes available IP to Global Medical (A). In particular:

- They all relate to the right to manufacture and sell high tech equipment
- 5 relate only to the use of marketing intangibles. The specified royalties range from 4% to 18% of turnover
- 3 relate to manufacturing IP only. The specified royalties range from 1.5% to 7% of turnover
- 4 relate to both manufacturing and marketing intangibles. The specified royalties range from 6% to 17% of turnover.

We thus conclude that 10% is a reasonable royalty rate.

To check that the use of a 10% royalty rate is commercially rational, we considered the operating margin projected to be earned by Global Medical (A) over the years 2011 to 2016, both before and after the payment of the royalty.

The results are summarised below:

	2011	2012	2013	2014	2015	2016
Turnover from sale of goods	120	128	138	148	158	170
Operating margin pre royalty	21	23	24	25	27	28
Royalty payable	12	12.8	13.8	14.8	15.8	17
Net margin (before tax and interest)	9	10.2	10.2	10.2	11.2	11
Net margin/turnover	7.5	8.0	7.4	6.9	7.1	6.5

This demonstrates that, after the payment of the royalty, Global Medical is projected to earn a healthy operating margin. We consider that the projected operating margin is in excess of the return that would be seen at arm’s length for a manufacturing/sales company that has no ownership of valuable IP.

AUDITING MULTINATIONAL ENTERPRISES

CUTTING EDGE EXAMPLE

6. Detailed information on Global Medical (A)'s business processes

Following your earlier reviews, you decide to interview two business people:

- Ryan Adams, Operations Manager at Global Medical (A)'s manufacturing plant
- Jeff Byrd, General Manager, Global Medical (A)

You are provided with notes of the two interviews, and two internal memoranda, and are asked to identify issues that you think may arise.

Extracts from Notes of Interview with Ryan Adams, Operations Manager, Global Medical (A) 20th July 2014.

1. Mr Adams had been appointed the Operations Manager of Global Medical on 1st January 2011. He had previously been with CE for 12 years and said he had “huge experience” of the design and manufacture of electronic diagnostic units. He said his role is to oversee the development and manufacturing process work carried out by the company’s manufacturing and R&D facility in Country A. He said that it was important that he was able to take an overview of both R&D and manufacturing as they were very closely linked. The R&D tended to be focused on improvements to existing models and it was important that the implications for the manufacturing process were considered at the same time. In addition, some of the R&D related to developing more efficient manufacturing techniques.
2. We said we would like to understand how the operations had changed since the acquisition by Global Medical. Mr Adams replied that, day to day, very little had changed as far as manufacturing and R&D were concerned. For the first two years after the acquisition, they were still manufacturing the same units, although on a larger scale because they were beginning to sell into a wider market through Global Medical’s distribution network. Even so, production has increased by only about 30% to date. The design and specifications of the units were continuously evolving and this year’s (2014) model incorporates a number of recent innovations that were developed by the Global Medical group in Country A and elsewhere.
3. We asked about his specific interactions with the Global Medical group. He said there were probably two. The first was that they had some contact with other group manufacturers, who were particularly interested in the manufacturing processes that Global Medical (A) had developed. There had been visits from staff of other manufacturing units, and some of Mr Adams’ R&D staff had been helping Global Medical plants in other regions design and modernise their manufacturing processes. The second was the introduction of much more paperwork on R&D projects.
4. When asked for more detail of the second point. He said that the approval of new R&D projects, and approval of funding for them, was now the responsibility of Global Medical IP Holdings. They also reviewed existing projects and made stop/continue decisions on a quarterly basis. This meant much more paperwork for him. In particular, he needed to obtain Global Medical IP Holdings’ approval for any new R&D project. In addition he had to compile a quarterly report in which he reported on the progress of existing projects and had to explain any major cost increases. He said that Global Medical IP

Holdings approved all new projects and authorised continuing expenditure on existing projects.

5. We asked him to explain in detail the process by which such decisions and authorisation are made. He said that the decisions have to be made by the Board of Global Medical IP Holdings, which meets in Genovia quarterly. In practice, of course, most decisions cannot wait until the next Board meeting. For example, if a particular customer is looking for a tailored modification to its units, then the R&D department will need to develop and test those modifications as soon as possible. Sales might be lost if the customer is forced to wait a few months. So in practice, Mr Adams makes a recommendation to Global Medical (A)'s Managing Director, Vic Chestnut, who is authorised to make "interim decisions" between Board meetings. This is very convenient because Vic's office is in the adjoining office complex. He explained that Vic is director of Global Medical IP Holdings, and flies out to Genovia for Board meeting four times a year. The Board will formally authorise the R&D projects at its next quarterly meeting. Mr Adams explained that he wrote up all these recommendations in his quarterly report to the Global Medical IP Holdings Board.
6. We asked whether he had any other dealings with Global Medical IP Holdings - he said not. He said he is "not sure anyone actually works in Genovia".
7. Mr Adams was asked to explain in more detail how he compiles the report. He said, in practice, he compiled a summary of each current R&D project and proposed new projects. This included a business case for each, including costs to date, expected future costs, expected business benefits and his recommendation as to whether to commence, continue or stop a project.
8. Mr Adams was asked to provide a copy of the last two reports. These showed that there are 5 current projects and two more in the pipeline. It was noted that most of the projects had commenced before approval by the Board. When asked how many projects are instigated under the delegated authority given to Vic Chestnut, Mr Adams thought this applied to "most of them". He thought that, in practice, the Board always approves his recommendations.
9. We asked to see copies of internal correspondence between Mr Adams and Mr Chestnut concerning the apprpval of R&D projects. (Sample correspondence is attached).

Extracts from Notes of Interview with Jeff Bryrd, General Manager, Global Medical (A). 31th July 2014.

1. We thanked Mr Byrd for his time and explained that we would like him to provide further information about the provision of HQ services from Global Medical HQ and the related charge.
2. As background, Mr Byrd explained that he had been with Global Medical (A) (formerly Cutting Edge Corporation) for about 10 years and had responsibility for all "back-office" work. He reported directly to the Board and his responsibilities included HR, all administrative systems (including IT), health and safety and regulatory compliance.
3. He said that, although the HQ service charge was quite high, he thought it "worth every cent". He said that the acquisition by Global Medical had brought great benefits for the former Cutting Edge business. Global Medical gave them access to new markets, and its global growth strategy meant that, potentially, it would be able to sell its products to most regions of the world. Furthermore, if Cutting Edge had not been acquired, it would have faced competition from Global Medical itself (and other firms in this industry) and would have struggled to survive. The acquisition ensured the long-term viability of the manufacturing plant in Country A. Furthermore, it was clear that Global Medical very much valued the R&D work carried out in Country A. In fact, the local R&D facility is to be the group's new "centre of excellence" for developing and testing manufacturing processes and product quality control, and this would bring new jobs and very advanced skills into Country A.
4. We asked him to be more specific about the actual services provided by HQ and he pointed us towards the transfer pricing report we had been provided with. He said we should have no concerns about the way these service charges are computed – it is fully in line with the Global Medical's policy and the same for all group companies. In fact he had been told that other tax authorities have been happy to accept the policy.
5. We said that we would like to understand in much more detail exactly what services had been provided and would like to look at the four categories of services in much more detail.
6. Starting with legal services, we asked what exactly was provided. Mr Byrd said that the main thing was advice on legal contracts. Under Global Medical's instructions, all new agreements for with contractors, suppliers and customers had to be e-mailed to HQ for their review and approval. The same applied to non-standard employment contracts. We asked how legal contracts were dealt with prior to the take-over. He said that (as now) the first drafts of contracts were drawn up in-house and, when it was thought necessary, they would be checked over by a local firm of solicitors. We asked whether they still engaged the solicitors for legal work. Mr Byrd said that they no longer use them for checking these sorts of contracts. We asked whether the local solicitor are used for any other type of legal work - and he thought they were, especially for HR issues (such as dismissal), where their knowledge of local employment law was very useful.

7. On IT services, the local group of companies now have access to the Global Medical's intranet, including e-mail, databases and systems for supply chain management. Prior to the take-over, the group had three dedicated IT technicians and also had a supply and maintenance contract with a third party IT systems providers. Since the takeover, the salaries of the IT technicians have been reimbursed from head office and they report directly to HQ. The group no longer needs to engage the outside IT contractor. The 24-hr helpline is much used by staff.
8. Turning to HR, Mr Byrd said that Global Medical (A) has adopted the Global Medical HR policy, which is backed by on-line guidance on such matters as hiring and dismissals, performance management and policies such as equality of treatment and anti-bullying. We asked who actually carries out local HR duties in Country A. Mr Byrd replied that this was carried out by a small local HR section, that was unchanged since the takeover – in fact it had taken on more staff since the acquisition to implement the new performance management systems that Global Medical insist on.
9. Finally, turning to the provision of "strategy and management" services, Mr Byrd said that this was the most valuable aspect of joining the new group. We noted that the costs of the Global Medical HQ directors had been included in this and we asked to see evidence of their direct involvement in the business of the local group. Mr Byrd said that it is very difficult to think of concrete examples, but pointed to the fact that he and other executives had attended internal training courses and conferences at which HQ directors were present and had provided excellent advice on such topics as management techniques and motivation. We asked whether any of the HQ directors had visited Country A. It seems there were a few visits just after acquisition, but not since. He could not think of any instances where any of the top HQ management had had any involvement in Global Medical (A)'s day-to-day business. He thought they would set strategy, but leave local management to implement it. He thought it was most important that the top HQ executives are working on growing the group into new markets, through acquisitions and organic growth. These increase the potential market for A's products, something that will be very valuable for the company.
10. Lastly, we noted from the files that insurance premiums are being paid to a Global Medical subsidiary (GM Insurance) in the Cayman Islands. Mr Byrd said that, with the increasingly litigious environment in the medical industry, it was extremely important to get adequate cover for, for example, liability arising from patient injury or misdiagnosis arising from a faulty machine or design error. He said that one of the other advantages of joining the Global Medical group was that they had access to the group's insurance subsidiary that provides "very comprehensive cover" at a commercial rate. We asked to see all supporting documentation. Mr Byrd assured us that he would be able to show evidence that the premiums paid to GM Insurance was no more than would be payable to a third party insurer for the same amount of cover.

Memorandum

To: **Vic Chestnut (Director, Global Medical IP Holdings)**

CC:

From: **Ryan Adams**

Date: 17th February 2011

Re: **Authorisation to commence a development project**

Can I have your authorisation to carry out a model-modification and feasibility project? The estimated cost is $25 000 and would be completed in about 4 weeks.

Background

The sales group is in advanced talks with the Portdown Hospital Group for the purchase from us of 10 Mark III units. The value of the sale would be about $1.3m.

The Group has indicated that they would require a modification to the standard Mark III machine which would allow images and results to be transmitted in real time from the units into the hospital's IT system. This would allow results to be saved centrally and viewed from any of the hospital's monitors.

We consider that we can make this modification fairly easily. It would need the development of a new sender unit and then need extensive testing, including on the hospital's internal system.

The cost of carrying out this project would be small compared to the likely sales that result. And it would produce an enhancement that we could offer to other customers – both our own and those in other parts of the group.

Memorandum

To: **Ryan Adams**

CC:

From: **Vic Chestnut**

Date: 18th February 2011

Re: **Authorisation to commence a development project**

Thanks Ryan for your memo of yesterday. I can confirm that you may commence the project and I authorise expenditure up to $ 27 500. I can confirm that Global Medical IP Holdings will reimburse all the costs of the project marked up by 5%.

Please ensure that full details are included in your report to the Global Medical IP Holdings' Board on 1st April so that we can formally authorise the expenditure then.