

The Z-Score Model: A Useful Tool for Intercompany Financial Transactions

One of the biggest challenges in pricing intercompany financial transactions is getting an accurate credit rating analysis of the borrower entity. Credit rating is a key factor that impacts interest rates. However, most subsidiary entities that borrow from affiliates under common control do not have their own standalone credit ratings, creating a challenge for transfer pricing analysis.

This is where the Z-score model, developed by NYU professor Edward Altman in 1968 and updated over the years, becomes a valuable tool. The Z-score provides a quantitative measure of a company's financial health and likelihood of bankruptcy. Importantly, Altman's research has established correlations between Z-score ranges and equivalent an

For transfer pricing practitioners, the Z-score model offers several advantages:

1. It can be calculated using financial statement data, without requiring a formal credit rating.
2. It provides an objective, quantitative basis for estimating a subsidiary's creditworthiness.
3. Altman's published data links Z-scores to equivalent credit ratings, allowing for benchmarking against market interest rates from corporate bonds.
4. The model has been updated over time, and although the analysis was targeted at manufacturers, it has proven pretty effective in predicting default in other industries as well. [Click here to learn more about Altman's Z-Score Model](#)

To apply the Z-score in transfer pricing:

1. Calculate the Z-score for the borrowing subsidiary using its financial data.
2. Reference Altman's tables to determine the equivalent credit rating.
3. Use the implied credit rating to benchmark appropriate interest rates based on market data for similarly-rated bonds.

While not a perfect substitute for formal credit ratings, the Z-score model offers a defensible, data-driven approach to estimating creditworthiness for transfer pricing purposes. When combined with other analyses and market data, it can help support arm's length interest rates for intercompany financial transactions.

As with any transfer pricing method, proper application and documentation of the Z-score approach is crucial. Companies should consider consulting with transfer pricing specialists to ensure the appropriate use of the model within their broader transfer pricing.