Annex to Chapter III

Example of a Working Capital Adjustment

See Chapter III, Section A.6 of these Guidelines for general guidance on comparability adjustments.

The assumptions about arm's length arrangements in the following examples are intended for illustrative purposes only and should not be taken as prescribing adjustments and arm's length arrangements in actual cases of particular industries. While they seek to demonstrate the principles of the sections of the Guidelines to which they refer, those principles must be applied in each case according to the specific facts and circumstances of that case.

This example is provided for illustration purposes as it represents one way, but not necessarily the only way, in which such an adjustment can be calculated.

Furthermore, the comments below relate to the application of a transactional net margin method in the situations where, given the facts and circumstances of the case and in particular the comparability (including functional) analysis of the transaction and the review of the information available on uncontrolled comparables, such a method is found to be the most appropriate method to be used.

Introduction

1. This simple example shows how to make an adjustment in recognition of differences in levels of working capital between a tested party (TestCo) and a comparable (CompCo). See paragraphs 3.47-3.54 of these Guidelines for general guidance on comparability adjustments. Working capital adjustments may be warranted when applying the transactional net margin method. In practice they are usually found when applying a transactional net margin method, although they might also be applicable in cost plus or resale price methods. Working capital adjustments should only be considered when the reliability of the comparables will be improved and reasonably accurate adjustments can be made. They should not be automatically made and would not be automatically accepted by tax administrations.

Why make a working capital adjustment?

2. In a competitive environment, money has a time value. If a company provided, say, 60 days trade terms for payment of accounts, the price of the goods should equate to the price for immediate payment plus 60 days of interest on the immediate payment price. By carrying high accounts receivable a company is allowing its customers a relatively long period to pay their accounts. It would need to borrow money to fund the credit terms and/or suffer a reduction in the amount of cash surplus which it would otherwise have available to invest. In a competitive environment, the price should therefore include an element to reflect these payment terms and compensate for the timing effect.

3. The opposite applies to higher levels of accounts payable. By carrying high accounts payable, a company is benefitting from a relatively long period to pay its suppliers. It would need to borrow less money to fund its purchases and/or benefit from an increase in the amount of cash surplus available to invest. In a competitive environment, the cost of goods sold should include an element to reflect these payment terms and compensate for the timing effect.

4. A company with high levels of inventory would similarly need to either borrow to fund the purchase or reduce the amount of cash surplus which the company is able to invest. Note that the interest rate might be affected by the funding structure (e.g. where the purchase of inventory is partly funded by equity) or by the risk associated with holding specific types of inventory.

5. Making a working capital adjustment is an attempt to adjust for the differences in time value of money between the tested party and potential comparables with an assumption that the difference should be reflected in profits. The underlying reasoning is that:

- A company will need funding to cover the time gap between the time it invests money (i.e. pays money to supplier) and the time it collects the investment (i.e. collects money from customers)

- This time gap is calculated as: the period needed to sell inventories to customers + (plus) the period needed to collect money from customers – (less) the period granted to pay debts to suppliers.

6. The process of calculating working capital adjustments:

a) Identify differences in the levels of working capital. Generally trade receivables, inventory and trade payables are the three accounts considered. The transactional net margin method is applied relative to an appropriate base, for example costs, sales or assets (see paragraph 2.64 of the Guidelines). If the appropriate base is sales, for example, then any differences in working capital levels should be measured relative to sales.

b) Calculate a value for differences in levels of working capital between the tested party and the comparable relative to the appropriate base and reflecting the time value of money by use of an appropriate interest rate.

c) Adjust the result to reflect differences in levels of working capital. The following example adjusts the comparable's result to reflect the tested party's levels of working capital. Alternative calculations are to adjust the tested party's results to reflect the comparables levels of working capital or to adjust both the tested party and the comparable's results to reflect "zero" working capital.

A practical example of calculating working capital adjustments:

7. The following calculation is hypothetical. It is only to demonstrate how a working capital adjustment can be calculated.

TestCo	Year 1	Year 2	Year 3	Year 4	Year 5
Sales	$179.5m	$182.5m	$187m	$195m	$198m
Earnings Before Interest & Tax (EBIT)	$1.5m	$1.83m	$2.43m	$2.54m	$1.78m
EBIT/Sales (%)	0.8%	1%	1.3%	1.3%	0.9%
Working Capital (at end of year)[1]					
Trade Receivables (R)	$30m	$32m	$33m	$35m	$37m
Inventories (I)	$36m	$36m	$38m	$40m	$45m
Trade Payables (P)	$20m	$21m	$26m	$23m	$24m
Receivables (R) + Inventory (I) – Payables (P)	$46m	$47m	$45m	$52m	$58m
(R + I – P) / Sales	25.6%	25.8%	24.1%	26.7%	29.3%

CompCo	Year 1	Year 2	Year 3	Year 4	Year 5
Sales	$120.4m	$121.2m	$121.8m	$126.3m	$130.2m
Earnings Before Interest & Tax (EBIT)	$1.59m	$3.59m	$3.15m	$4.18m	$6.44m
EBIT/Sales (%)	1.32%	2.96%	2.59%	3.31%	4.95%
Working Capital (at end of year)[1]					
Trade Receivables (R)	$17m	$18m	$20m	$22m	$23m
Inventory (I)	$18m	$20m	$26m	$24m	$25m
Trade Payables (P)	$11m	$13m	$11m	$15m	$16m
Receivables (R) + Inventory (I) – Payables (P)	$24m	$25m	$35m	$31m	$32m
(R + I – P) / Sales	19.9%	20.6%	28.7%	24.5%	24.6%

1 See comment at paragraph 8.

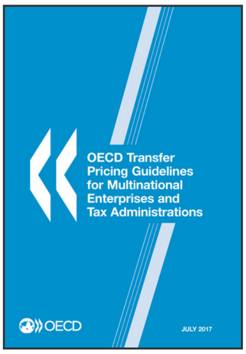
Working Capital Adjustment	Year 1	Year 2	Year 3	Year 4	Year 5
TestCo's (R + I – P) / Sales	25.6%	25.8%	24.1%	26.7%	29.3%
CompCo's (R + I – P) / Sales	19.9%	20.6%	28.7%	24.5%	24.6%
Difference (D)	5.7%	5.1%	-4.7%	2.1%	4.7%
Interest Rate (i)	4.8%	5.4%	5.0%	5.5%	4.5%
Adjustment (D*i)	0.27%	0.28%	-0.23%	0.12%	0.21%
CompCo's EBIT/Sales (%)	1.32%	2.96%	2.59%	3.31%	4.95%
Working Capital Adjusted EBIT / Sales for CompCo	1.59%	3.24%	2.35%	3.43%	5.16%

8. Some observations:

- An issue in making working capital adjustments is what point in time are the Receivables, Inventory and Payables compared between the tested party and the comparables. The above example compares their levels on the last day of the financial year. This may not, however, be appropriate if this timing does not give a representative level of working capital over the year. In such cases, averages might be used if they better reflect the level of working capital over the year.

- A major issue in making working capital adjustments involves the selection of the appropriate interest rate (or rates) to use. The rate (or rates) should generally be determined by reference to the rate(s) of interest applicable to a commercial enterprise operating in the same market as the tested party. In most cases a commercial loan rate will be appropriate. In cases where the tested party's working capital balance is negative (that is Payables > Receivables + Inventory), a different rate may be appropriate. The rate used in the above example reflects the rate at which TestCo is able to borrow funds in its local market. This example also assumes that the same interest rate is appropriate for payables, receivables and inventory, but that may or may not be the case in practice. Where different rates of interest are found to be appropriately applicable to individual classes of assets or liabilities, the calculation may be considerably more complex than shown above.

- The purpose of working capital adjustments is to improve the reliability of the comparables. There is a question whether working capital adjustments should be made when the results of some comparables can be reliably adjusted while the results of some others cannot.



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