Significance of working capital in transfer pricing analysis 2/44/21


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Our Flash News edition of 17 May 2019 and 23 May 2019 looked at the significance of working capital in a company's business. This article explores when and why we need to assess working capital in a transfer pricing analysis.

Every company should have sufficient funds enabling it to duly cover staff costs, taxes and accounts payable to suppliers, including costs incurred in transactions with related parties.

A company's ability to pay off debts arising in the course of business is reflected by its working capital ("WC"), computed as current assets less current liabilities. Efficient use of WC directly affects the company's profits and cash flows.

Every company plans its WC cycle—the number of days from ordering inventories to receiving cash for sales. The longer this period, the more the company has to earn to finance its inventories and other business costs. This has to do with the time value of money being driven by various factors, for example:

- The fact that money today is worth more than it will be in the future (if it is received after some time)
- Capital that is tied up in inventories or in the value of goods/services sold and which could be used alternatively to earn some extra profit by investing them in other more profitable assets
- Extra funds borrowed with interest to compensate for a lack of finance required to run the business

Accordingly, the later we receive cash for the goods/services sold and the earlier we pay our suppliers, the more money we need to invest in financing our WC. So the size, availability and financing of WC required for business directly affects our profit. And that is when WC might affect the transfer pricing analysis since examining a Latvian company's transactions with related parties for compliance with the arm's length principle often involves assessing the profit margin the Latvian company ("tested party") earns in its related-party transactions. As part of the transfer pricing analysis, the tested party's margin is compared with margins earned by comparable independent companies making up the arm's length range. If the tested party's margin is within the arm's length range, its related-party transaction can be recognised as arm's length.

If the tested party's business is sufficiently similar to the business of selected independent companies, the question of WC does not usually arise because this indicator, too, should be comparable with other companies. However, there are also different cases:

- The tested party sells goods/services to a related party but receives consideration over a longer period than is usual for transactions between unrelated parties (e.g. every six months).
- The tested party operates as a provider of procurement and logistics services, selling goods to related companies with little or no markup, and earns a profit only from logistics services. Accordingly, it compares its profit margin to logistics service providers that neither buy goods

nor finance inventories.

- The related company remunerates the tested party as a sales agent and compares its profit margin with independent sales agents but it actually holds inventories and finances goods etc.

If the business done in the tested party's controlled transactions substantially differs from the business done by comparable companies, we need to consider whether this difference is reflected in the WC cycle. If the answer is yes, we should consider the need to make a WC adjustment to the arm's length range.

The OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations[1] recommend a WC adjustment when it comes to assessing the value of timing differences between the tested party's profit margin in its controlled transactions and the margins of unrelated parties in a comparable business and determining an adequate fee for financing the goods/services concerned. This recommendation assumes that the profit should reflect these differences, as the company needs funding to cover the space between investing money (i.e. payment to suppliers) and recouping money (i.e. payment from customers).

The timing difference is computed according to this formula:

WC adjustment

= time it takes to sell goods to customers

\+ (plus) time it takes to receive payment from customers
– (minus) payment period set by suppliers

The OECD guidelines describe how a WC adjustment is computed in the following steps:

1. Computing the WC indicator – an example offered in the guidelines uses the indicator *WC / turnover (%)* but this should be aligned with the profit indicator. For example, if the markup on cost is being examined, WC will also be divided by cost.
2. Computing WC differences between the tested party and comparable unrelated companies: *WC / tested party's turnover x 100% – WC / comparable companies' turnover x 100%*.
3. Determining the time value of money by reference to an arm's length WC financing (loan) interest rate: (*WC / tested party's turnover x 100% – WC / comparable companies' turnover x 100%) x loan interest rate.*
4. An arm's length range adjustment – the WC adjustment computed in the previous step is added to the operating margins of comparable companies.

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[1] OECD guidelines, paragraph 3.49 and Annex to Chapter III: Example of a Working Capital Adjustment