Arms Length Standard

Financial ratio analysis for thin capitalisation purposes

By Steven Breslin

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In the draft Interpretation Note on thin capitalisation SARS provided certain financial ratios in selecting potential thin capitalisation cases for audit. In selecting cases, SARS will consider transactions in which these ratios exceed a certain threshold to be of greater risk. The ratios indicated by SARS are not a safe harbour and does not preclude SARS from auditing a taxpayer who is within the range. The ratios are merely indicative of the level of risk set by SARS for the purpose of selecting cases for audit. It is accepted that the ratios may vary in different industries and according to the creditworthiness of the particular taxpayer. Accordingly, the ratios may not be indicative of what constitutes an arm's length position for a particular taxpayer or industry; the ratio are merely used as a potential risk identifier.

The ones referred to were as follows:

- Debt: EBITDA;
- Interest cover ratio; and
- Debt: Equity.

The previous SARS practice note applicable to thin capitalisation (SARS Practice Note 2) applied yet another ratio – namely financial assistance, ie debt to "fixed capital", a defined term with a very specific meaning.

It is also our understanding from subsequent discussions with SARS, that further ratios could be used to determine the arm's length position. These include debt to fixed assets – a ratio which is sometimes helpful in asset intensive industries such as mining.

It is therefore important to consider the various ratios which can be used when testing various cross-border transactions. Furthermore, consideration should be given to the fact that there are some businesses where the income statement can provide a meaningful result of the company's performance whereas with other businesses, which are more capital intensive, the balance sheet may provide a better indication of a company's financial position.

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It is helpful, for example, to consider how to assess the operations of a distributor, whose functions are mainly to market and sell its products. With this type of operating model, a distributor typically does not have significant assets on its balance sheet and its success depends generally on aspects such as warehousing/ its storage facilities and efficient transportation of goods. Therefore, the ratio analysis of the income statement should provide a meaningful result – for example, by assessing return on sales (gross and operating margins).

The same is true for a manufacturer of goods, where an analysis can be done of the manufacturer's return on costs. In addition, further consideration will need to be given to the fact that a manufacturer may also have a significant amount of assets recorded in its balance sheet such as buildings, machinery and equipment. Therefore an analysis of the balance sheet can also be done to assess such ratios as the return on capital employed or the manufacturer's debt to its assets (for thin capitalisation purposes).

However, there are some pitfalls which need to be taken into account when using certain ratios, namely:

- **Limited Risk Models:**

  When applying certain ratios to operating models such as a limited-risk model, it needs to be borne in mind that, in the case of the limited risk distributor, this model generally limits the profitability of the entity concerned. More specifically, transfer prices are set (and often adjusted) to ensure that the entity achieves an operating margin which falls within the inter-quartile range. Therefore, since the company's profit potential is limited, the use of the Debt: EBITDA ratio, and more specifically, the EBITDA line item in the income statement will, in all likelihood, create a distorted view of the company's ability to service its existing debt. This is because of the fact that a limited risk entity does not have significant amount of fixed assets such as property and equipment and therefore does not have significant depreciation which in turn would have an impact on the EBITDA number. Therefore, preference should be given to the debt: equity or interest cover ratios since these ratios provide a better indication of the company's ability to maintain its debt position instead of the debt: EBITDA ratio.

- **Mining Companies:**

  The profitability of these types of company is heavily reliant on movements in commodity prices and hence their profitability can be considered to be volatile in most cases. If a mining company receives financial assistance in the form of funding or guarantees and we are testing whether the mining company is thinly capitalised, it is therefore necessary to consider the income statement or the balance sheet provide a more meaningful indication of the company's ability to service its debts?

Due to a mining company typically being highly asset intensive, when considering the income statement ratios for thin capitalisation purposes (namely, Debt: EBITDA and interest cover), this tends to indicate, in most case, that the company is highly geared and cannot take on debt. However, this situation may not be true when applying balance sheet ratios such as the Debt: Fixed Assets[1] in that the value of the assets may be greater than the debt of the company. This might indicate that these assets could be used as collateral to finance part or the full amount of the debt.

- **High Asset Intensity Operating Models in Loss-Making Positions:**

  The same point often applies to companies which carry significant amount of assets in their balance and are in a loss-position. Once again, typically the use the income statement ratio would indicate that the company cannot support its level of debt. However, when we use the balance sheet, and more specifically the Debt: Fixed Assets, the results may indicate that the company has assets which are greater than its liabilities and therefore, would be able to use its assets as collateral to finance additional debt.

  From a risk perspective, SARS would deem a high Debt to EBITDA ratio as a risk that the company is thinly capitalised. However, to come to a decisive answer the answer is not that simple and it would be important to understand the reason why the company required the debt funding, the industry it operates in and compare it as such.

  Accordingly, the way in which to assess a company's financial position for thin capitalisation purposes is complex and there are multiple factors which could determine the correct approach. The guidance provided by SARS in the draft Interpretation Note was somewhat limited and only touched on certain of the ratios and approaches which could potentially be useful.

[1] This is a leverage ratio that defines the total amount of debt relative to assets. The higher the ratio, the higher the degree of leverage, and consequently, financial risk. A company with a ratio of greater than 1 means the company has more liabilities than assets. This company is extremely leveraged and highly risky to invest in. A company with a ratio of less than 1 shows that it has more assets than liabilities and could pay off its obligations by selling its assets if it needed to. This is the least risky of the three companies.