Managing complexity in intercompany transfer pricing

Anthony Bevacqua and Jerry Klopfer of KPMG discuss the growing difficulties experienced by organisations trying to safeguard against the pitfalls of intercompany arrangements. Collaboration between operations and information technology is key.

Many multinational companies struggle with the resource-intensive requirements to manage intercompany arrangements, which can involve complex collaboration among people in tax, finance and accounting, operations and information technology. Large multinationals can create value and reduce risk by aligning transfer pricing policy with day-to-day operations through well-defined business processes and technology solutions. This requires a holistic view and cross-functional execution that can be challenging, even for large multinationals that are good at other aspects of global integration.

Multinational companies that engage in complex intercompany arrangements spend significant time developing efficient transfer pricing strategies and policies that conform to tax regulations. Getting the up-front design right is a critical component of tax risk management, and is part of the foundation on which other ‘downstream’ processes depend. However, to achieve the desired results, it is necessary to design business processes and systems that are broad-based enough to meet the business requirements and the cross-functional aspects of transfer pricing implementation. If not, companies can face real consequences, including mis-stated financial statements and increased tax liabilities.

Achieving alignment
Transfer pricing strategy, intercompany transaction processing, and accounting requirements are complex. This challenge requires process design and coordination across various independent units within one organisation. As a result, the alignment process can be daunting.

From the people perspective, multinational companies may lack broad, intercompany process ownership and have limited knowledge of how the entire process should work across the intercompany environment. Like any cross-functional process, each unit may be executing well, but without a clear, overall, process owner, communication breakdowns between units can occur. These miscommunications can result in process inefficiencies, accounting errors, noncompliance with tax policies, and higher-than-necessary tax payments. From the process perspective, different intercompany arrangements can require unique business designs. Processes do not always follow standard procedures and often can involve the transfer of products or services across many legal jurisdictions underpinning intercompany pricing policies. These different variants can include plant-to-plant transfers, intercompany sales, tolling arrangements, service allocations, and royalties – often having very specific and intrinsigent rules.

In an environment where many multinationals are striving to maintain competitiveness through global standardisation, a nonstandard process driven by tax policy can be counterintuitive to the business objectives and directions from the leadership. This can lead to friction between the tax and supporting business functions, resulting in ‘push-back’, against requests to implement a non-standard business process to support the transfer pricing policy.

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Areas for consideration
In technology, the main issues focus on data and the proliferation of finance, accounting, and operational systems. Effective implementation of transfer pricing policies depends heavily upon the accounting system environment. Many companies have multiple Enterprise Resource Planning (ERP) systems operating around the world due to historical factors. Multiple ERP systems with different data structures can lead to inefficiencies, increase the potential for inconsistent implementation of transfer pricing policies, and make it considerably more difficult for managers to monitor results and detect issues throughout the year.

Standardisation of data structures is much more difficult if spread across non-integrated, disparate systems. Many organisations that have implemented common ERP systems have made significant improvements in intercompany processing since these higher-end systems typically provide functionality to track and automate transactions through common data structures. However, even with sophisticated ERP systems, intercompany design remains a challenge, due to the number of applications and data sources required. All of the necessary ERP modules may not be within the scope of the ERP programme, or simply not configured to properly support the intercompany requirements.

Reporting can also be problematic since the data comes from distinct but coordinated modules, and might not be readily available in a standard format. The required data may have to be extracted from the underlying transaction systems and modelled to provide reporting and analytical capabilities to evaluate and monitor the results and intercompany profit allocations effectively.

Even in sophisticated ERP systems, the data may not be structured at the transaction level for streamlined reporting of internal profitability on both a ‘marked-up’ and ‘profit-eliminated’ basis. In these situations, it is not uncommon for organisations to rely on manually intensive, spreadsheet-driven reporting processes that are potentially inefficient and prone to error. Given these issues, it is not surprising that organisations that have adopted tax-efficient transfer pricing structures may face difficulty in forecasting tax rates, as profit mixes will change over time. To address these challenges, multinationals should also consider certain actions, such as implementing a framework that can be used for assessment and continuous performance improvement, which can lead to more efficient processes, improved monitoring of intercompany profit, and reduced risk.
A multinational seeking to improve its intercompany environment may consider establishing a cross-functional committee with a mandate to govern and manage intercompany processes. This committee should have adequate representation from all key functional constituents, with responsibilities to oversee the execution of all processes in accordance with tax policy and accounting requirements. It should also be responsible for identifying improvement opportunities, making recommendations to senior management, and implementing required changes to continuously improve the intercompany environment. Once the governing committee is in place, tactical level teams can be implemented in the form of a ‘centre of excellence,’ which will be responsible for day-to-day process execution and the monitoring and adjusting of results.

Enhanced environment
The next step is to conduct a comprehensive assessment of the intercompany environment. Multinationals may consider an evaluation that addresses all aspects of the intercompany life-cycle, including transfer pricing policy design, budgeting and forecasting, transaction execution, monitoring and adjustments, month-end accounting close, and tax compliance reporting. One question is whether responsibilities across the wide-ranging process need to be clearly defined and documented. Organisations that employ leading practices ensure that the tax, legal, and finance teams work together to set transfer pricing policies, codify those policies in intercompany agreements, define detailed accounting requirements and, most importantly, develop a framework for addressing areas of ambiguity as they arise. Ideally, processes should flow through the organisation so that not only is the business made aware of changes in transfer pricing policy, but a mechanism also exists to alert the tax department when changes in intercompany trading are adopted by the business.

The assessment is intended to identify such process issues so appropriate action can be taken to redesign handoffs and adjust procedures. The assessment enables each company to comprehensively document the process using a format that delineates execution responsibilities across functional boundaries. Companies should also consider formal communication, training, and a knowledge management programme. Even with formal documentation, having knowledge concentrated in a select few individuals is a risk in any business process. In cases where there is already ambiguity and a lack of thorough process governance, the risk may become critical.

A corresponding risk also exists that employees in the finance and accounting function, which may see a higher rotation of staff than tax departments, have no context to understand its role in the transfer pricing process. Organisations should look to put in place communication and training frameworks that extend across the tax, legal, finance, accounting and operational functions, to prevent personnel changes from causing significant disruptions in intercompany accounting.

Driving technology forward
IT organisations and the implementation of enabling technologies require the translation of process and policy design into technical specifications and data requirements to be captured in the underlying transactional systems and reporting databases. This can involve implementing changes to the data structures and transaction workflows in existing ERP systems, defining scope of new installations, or enhancing an existing ERP footprint with new tools. Leading organisations are beginning to implement purpose-built business intelligence applications specifically designed to address intercompany process and reporting requirements.

Data architecture is designed to extract key intercompany transaction-level data into a data warehouse environment that can interact with robust reporting tools. This type of architecture can be used to provide a staging area for intercompany elimination processing, as well as dashboard reporting to provide insight into profitability and transfer pricing results on both a past and future basis. Once the previous steps have been taken, the final stage is to implement a continuous improvement programme and overall mindset across the entire team. This requires establishing process owners to monitor the performance of the process, and should utilise a framework of appropriate performance metrics to maintain a heightened awareness of the strategic importance of a well-functioning intercompany process at the executive level.

Complex intercompany arrangements can be challenging for the multinational, and can compete with other business objectives including global standardisation. Multinationals that take a holistic view of the transfer pricing and intercompany accounting environment – fully aligning people, processes, and supporting technologies – should be better positioned to implement tax policies as intended, mitigate financial statement risk, streamline back-office resource requirements, and manage any tension with the broader business strategy.

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