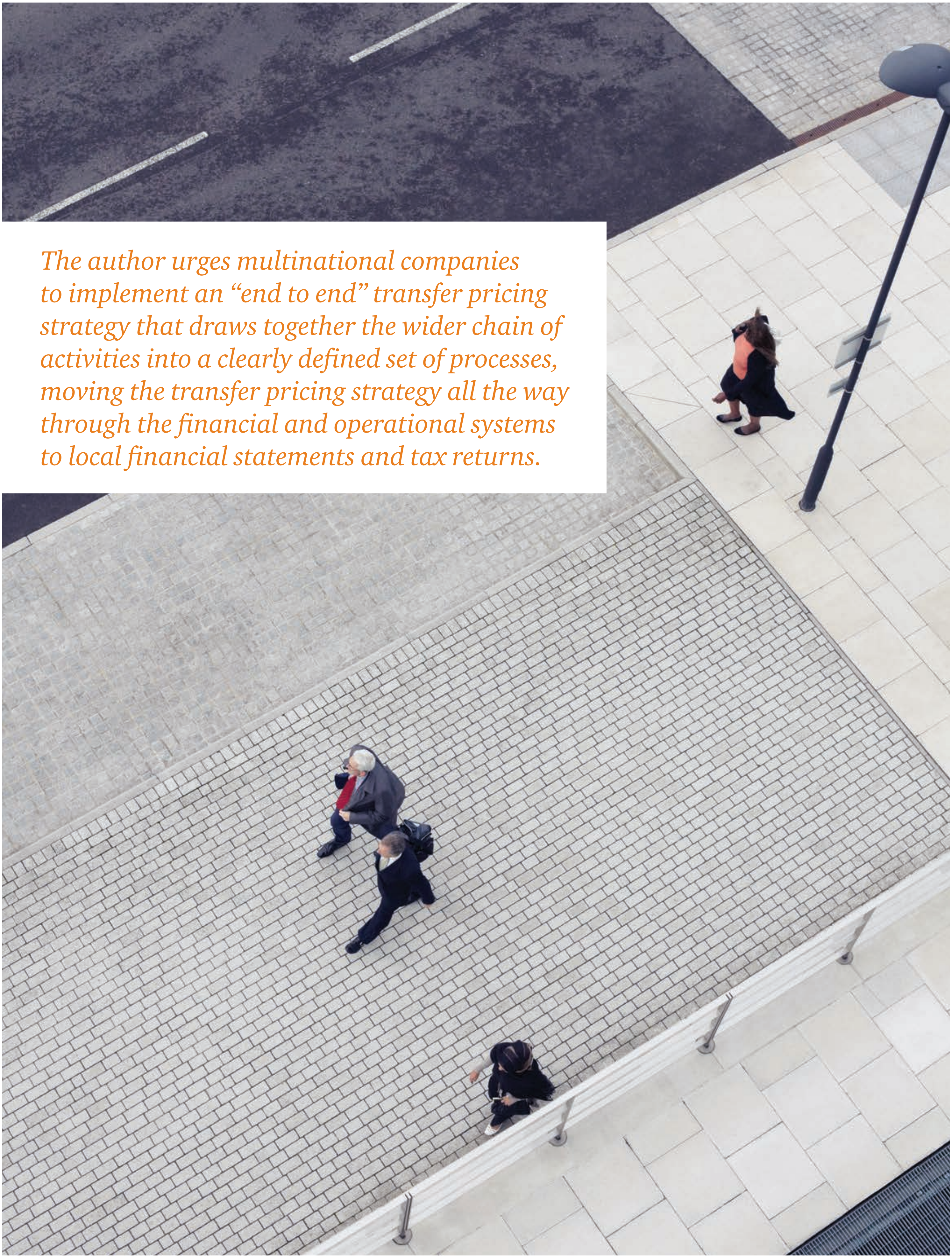
Beyond the tax department: Transfer pricing 'end to end'



The author urges multinational companies to implement an "end to end" transfer pricing strategy that draws together the wider chain of activities into a clearly defined set of processes, moving the transfer pricing strategy all the way through the financial and operational systems to local financial statements and tax returns.

Beyond the tax department: Transfer pricing 'end to end'

For the vast majority of tax executives, the practical execution of transfer pricing within an organization can present more frustration and confusion than any legislation or regulations. Compared with the efforts required to marshal various colleagues within a business to apply the company's transfer pricing strategy consistently and accurately, negotiating the world of economic analysis, policy setting, and documentation may seem like the proverbial piece of cake.

At the root of the challenge for tax executives is the fact that intercompany transactions comprise a complex series of processes that are typically seen as low risk involving multiple parts of an organization.

So while tax professionals likely care very deeply about how effectively intercompany transactions are executed, they must rely on regional and global controllers' offices, shared services centers, information technology professionals, and the corporate legal department—all of which may exhibit varying levels of support and commitment to the overall goal. Rarely is there one individual or team with oversight of the entire end-to-end (E2E)[1] process, so typically the wider chain of activities is never drawn together into a clearly defined set of processes. At best, this isolation—into what are often referred to as "silos"—results in frustration and wasted time; at worst, it results in material error or misstatement.

Overcoming the Hero Complex

In discussions with corporate tax leaders about transfer pricing execution, a remarkably common fact pattern emerges:

- an over dependence on specific individuals who spend significant time on data collection and analysis from a patchwork of data sources;
- reliance on a myriad of spreadsheets that only a few individuals understand;
- few mechanisms for formal control or reconciliation;
- the financial close table is met by relying on a series of informal hand-offs between internal functions;
- a dependence on financial controllers who frequently struggle to understand what the transfer pricing agreements and policy actually mean;
- hope that the result at year-end will be roughly in line with expectations.

This, of course, should not be a bit surprising. Tax professionals are by nature people with broad shoulders and a strong responsibility ethic. They get things done when others let them down. In the corporate culture, the tax department typically will do whatever it takes not to slow down the financial close processes even if the teams around them are struggling to meet predetermined timetables. While this is of course a highly admirable quality, when it comes to interdependent processes it can result in tax taking on responsibility for tasks that are better handled elsewhere in the organization.

The last 20 years have seen a revolution in the way in which finance functions have operated. The trend toward shared services operations and centers of excellence has led to significant economic savings, but has brought a certain ruthlessness to the "scoping" of services provided internally. As finance teams have been put under increasing pressure to do more with less, they have scaled back the services they provide to other teams. This has been so extreme in some organizations that tax departments have found themselves taking on responsibility for issues like the preparation of local country statutory accounts because other internal groups may choose not to support this activity. Just as other teams have reduced their reach, tax departments have ended up having to do a lot more with a lot less.

Faced with an ever-expanding punch list and limited ability to hire new resources, transfer pricing professionals may think the technology space holds a silver bullet that will make all of their problems go away. Technology is absolutely a key driver here, and may result in significant time savings, but experience suggests that the starting point must be the cultural, communication, and process issues. In other words, transfer pricing first must be seen as an end-to-end issue for which the entire enterprise must take ownership, and which must be reflected in processes and tasks that are executed consistently.

[1] "End to end" refers to the processes that flow from the transfer pricing strategy all the way through the financial and operational systems and end with local financial statements and tax returns.

Whose Job Is It Anyway?

It is critical to address the ambiguities of role and responsibility that commonly exist across intercompany processes. The goal is a formal process that clarifies the respective responsibilities that all relevant internal functions have in the execution of transfer pricing strategies. Figure 1 illustrates how this can be documented.

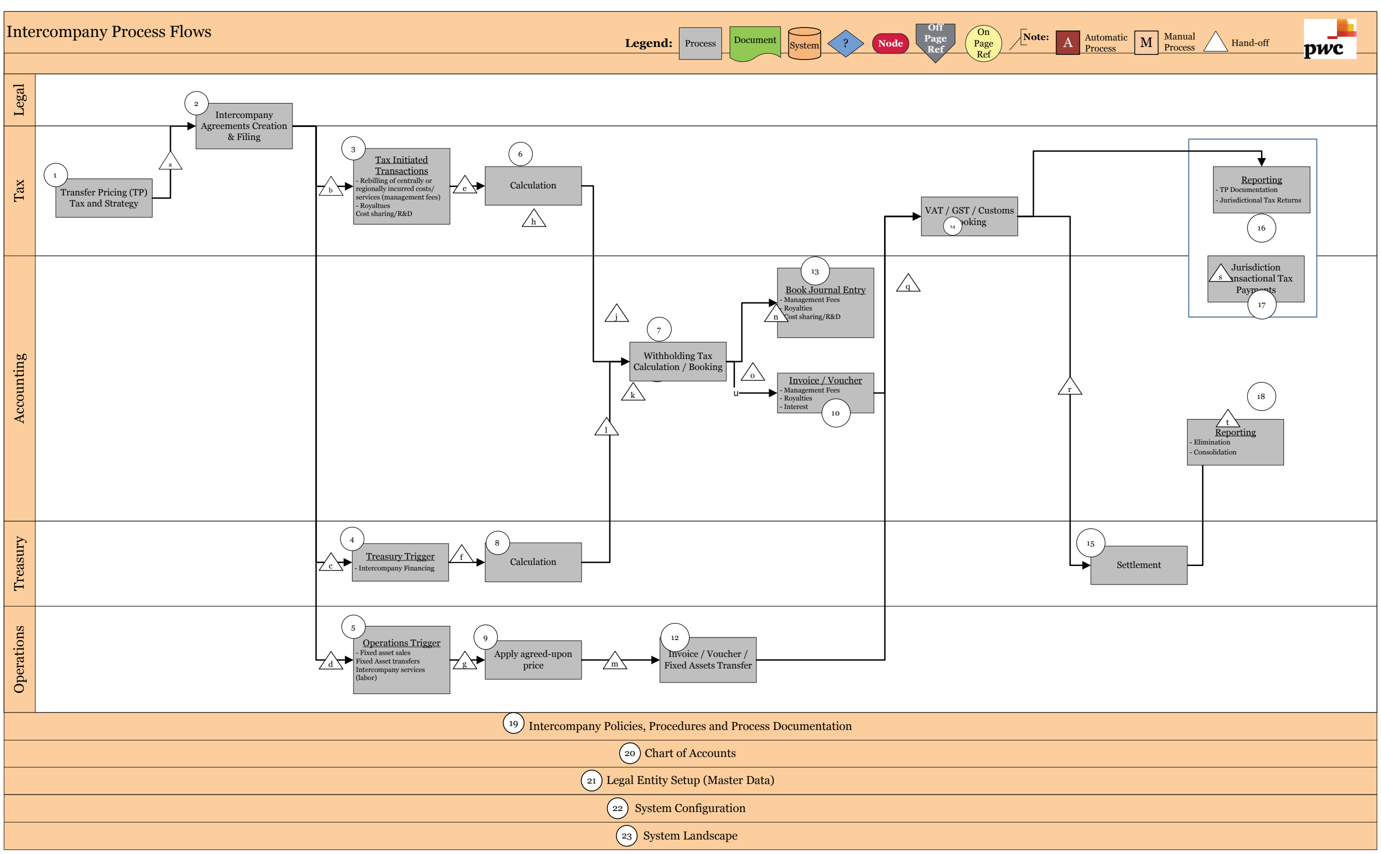
However, it is important to remember that more valuable than the production of this sort of document is the work undertaken to compile it and the benefits achieved when teams start to follow the "playbook."

By its very nature, assessment of the existing situation will involve bringing all relevant teams around the table, working methodically through the current tasks being performed, and comparing those findings to what should be happening. This type of exercise identifies where there are gaps in understanding, where inefficiencies are being introduced, and, critically, where the mismatch of data and activity leads to the end result deviating materially from plan. Risks are introduced at every point where responsibilities are transferred within the organization and where a task is itself poorly designed and controlled. Although the tax team may believe it has a view on what is or should be happening, it is extremely important to have financial and IT colleagues fully engaged in this process; their participation is necessary to truly understand the detail of execution, but also to ensure their buy-in to the design of the future.

While a key driver for undertaking this exercise may be to improve efficiency, one should expect it to reveal hard errors, such as the following examples:

- accounting policy mismatches, which commonly result from currency differences, accounting method differences, or below-the-line charges such as equity based compensation;
- accounting execution errors, which might relate to accounting entries held in sub-consolidations and not pushed down to local statutory financial statements, forecast data not aligning with data needed to deliver the current-year transfer pricing result;
- internal control weaknesses, which could include inconsistent versions of accounting data at various steps in the E2E process, profit and cost center mismatches, target operating margin calculations that are not defined at the general ledger level, or a lack of information technology controls surrounding manipulation of cost and profit data; and

Figure 1. Intercompany process flows example



- inconsistencies between income and transaction taxes, resulting in sub-optimal decision making when the total tax impact is considered.

Formalizing the hand-offs between functional units enhances the internal control environment and ensures a clear division of responsibilities between specific functions.

The tasks outlined below also must be completed to ensure a robust execution of transfer pricing.

It's All in the Definition

Before tasks are handed over to the rest of the organization to execute, it is critically important to ensure that both the legal agreements and the planned execution model align with the business's transfer pricing strategic plan. In other words, all material transaction flows should be reconciled to the core transfer pricing documentation, ideally through a governance process that ensures agreements are in force, maintained, and catalogued. In addition, formal document management of the transfer pricing documentation is recommended. For indirect taxes and customs duties, requiring formal sign-off on above-the-line treatment will reduce surprises at the end of the reporting period.

Creating detailed how-to implementation documentation for the controllership function that reconciles to the general ledger cost and profit structures can greatly improve the implementation of a transfer pricing strategy. Organizations and advisors often craft intercompany agreements with a somewhat broad scope, without sufficiently addressing the precise details of implementation, which can leave certain items open to interpretation. Precise definitions can reduce errors and implementation issues. Transfer pricing documentation might specify a price range, but someone has to tell finance what, exactly, to input into its master price files in the enterprise resource planning (ERP) system. Furthermore, execution of a transfer pricing strategy often relies on a number of factors not considered at all in the organization's formal transfer pricing policies. These items may introduce risk and jeopardize the company's successful implementation of its plans.

Even the seemingly most straightforward transfer pricing strategy can fail in the initial hand-off from tax to accounting. For example, implementation of a cost plus transfer pricing method can go awry if there is a discrepancy between the tax department and the accounting function regarding the precise definition of cost centers to be considered. The tax department may think the cost descriptions in an intercompany agreement are clearly defined. But if the costs do not clearly relate to general ledger accounts, the accounting team may use accounts that it views as a practical alternative.

Similarly, when it comes to entities being priced to a target operating margin, all sorts of other issues arise. How should foreign exchange costs be treated? Should below-the-line charges, such as equity-based compensation, be included in the calculation? Special consideration also should be given to the accounting principles applied throughout the enterprise. Whether US generally accepted accounting principles, international financial reporting standards, or local jurisdiction rules are the basis for a unit's financial reporting can cause variation in how and where certain costs are accounted for within the organization. Attention also must be paid to where costs held at the sub-consolidation level flow through to the statutory financial statements.

To address these issues, the leading practice is for the tax function to create a document that clearly sets out the corporate transfer pricing policy and intercompany agreements, and thereby allows for a smooth hand-off of transfer pricing from tax to the finance function. This "accounting logic" should be prepared by the tax team in conjunction with finance and prepared in such detail to enable a controller, far removed from the center of the organization, to execute the transfer pricing with clarity. Without such a formalized approach, someone inevitably will have to interpret the transfer pricing strategy, and it is unlikely to be someone who understands the technical detail of what is trying to be achieved. If tax takes responsibility for making these types of determinations and formally documenting the interpretation, transfer pricing execution errors that might lead to unexpected results can be eliminated.

In the same way that controllership functions require a clear set of instructions, when it comes to forecasting, the tax department requires the same in reverse. However, forecasting typically is prepared with a regional, divisional, or top-line focus; this rarely is sufficient to enable accurate tax rate forecasting where transfer pricing plays a large part in driving the rate. This problem may be compounded when the transfer pricing strategy is particularly complicated (for example, after a tax-efficient operational reorganization) and complex structures may be more vulnerable to gaps between the forecast and actual results. Robust data modeling can be used to identify the inputs that have the greatest impact on rate and to estimate allocations under various scenarios, and support the case for greater detail in the overall forecasting process.

Talk to Me, Please

Tax professionals are very familiar with the need to reach out to the wider business and to communicate proactively. This can be both time-consuming and costly. Nevertheless, significant improvements can be achieved by ensuring that all players in the E2E process are trained in their respective roles and that business changes are communicated to the tax department in a timely manner. Formalizing the communication process and training among transfer pricing, accounting, and indirect tax personnel can help ensure emerging issues are considered on a timely basis. This is especially important for large organizations and business that use shared services structures.

Targeted training materials should describe exactly what business unit controllers need to understand about the transfer pricing strategy, the entire E2E process, and the controllers' specific role. Specific items to address include:

- the controller's specific weekly, monthly, and quarterly roles;
- how uncertainties that arise in interpretation should be addressed;
- what items the controller should look for (for example, previously undocumented intercompany transactions, potential withholding tax exposures); and
- how and to whom exceptions should be communicated.

In addition to training existing staff, new accounting and tax personnel must receive appropriate training on transfer pricing and controls when they are hired.

Organizations also should recognize that changes in tax strategy, general ledger hierarchy, and information technology systems occur frequently; they should update E2E processes when these changes occur. Monitoring should not occur as merely a snapshot in time, but rather as an ongoing process; it is important to build in the communication protocols that apply to such changes as they arise. Personnel turnover also requires diligent effort with training and monitoring.

Further, any contemplated changes in tax strategy should address the needs of those involved in execution. And, once implemented, changes must be communicated effectively throughout the E2E process.

Changes in the general ledger hierarchy must be communicated to the tax department in a timely manner to ensure that corresponding changes to accounting models are made promptly. Certain changes (for example, adding a new cost center) may be more obvious, while other changes (such as using an existing account for a different purpose) are more likely to be overlooked. Other trigger events that should be communicated include acquisitions, dispositions, and changes in business structure.

Automation and Technology

Automation—and its corresponding benefits—is the final component to consider. Once a detailed understanding of the overall E2E processes has been developed, and all functions understand the strategy aims, the necessary data and systems requirements may then be determined. It is very important to proceed in that order—the last thing an organization would want to do is to replace a bad manual process with a bad automated one.

Automating processes can reduce risk, inefficiency, and time spent on non-value-added activities, such as data gathering and spreadsheet management. Systems and data issues are embedded throughout the intercompany accounting and transfer pricing E2E processes. Figure 2 illustrates the typical data demands of different types of transaction flow.

Financial systems need to be sensitized for data elements required to accurately perform transfer pricing calculations, including:

- transactional and source systems (pricing, standard costs, invoicing);
- general ledger systems (fully loaded costs, profit and loss);
- consolidation systems (management reporting, legal entity reporting);
- data warehouses (compilation of transactional and general ledger data);
- knowledge management systems (document management, non-general ledger data); and
- tax systems and work papers (transfer pricing calculations, tax reporting).

Understanding these systems becomes difficult if the organization has not taken an enterprise-level view of the transfer pricing process. Companies may find it beneficial to create a process map that identifies each function and where it should take place within the organization. Mapping the various transactions of the business also may help in making these determinations.

The most beneficial technology solution—which may range from simple desktop tools to a fully embedded business intelligence system—should be customized to meet each organization's specific needs.

Figure 2. Data requirements for different transaction types

Transaction flows arising from operations	Transaction flows arising from transfer pricing policy
Transactions generally initiated by business/supply chain	Transactions generally initiated by tax/group finance
Controls and processes regarding recording of entries likely to be stronger	Manual processes – typically reliant on spreadsheets
Tax department has input into pricing and reviews compliance post-transaction	Tax department gathers data and generates intercompany charges in line with policy
Data challenges are: • Ensuring operations follow pricing guidance • Handling large volumes of transactional data • Understanding the changing nature of supply chain and impact on availability/meaning of data • Complexity: Are systems able to cope with SKU-level data? • Interfacing with standard costing methodology/timing to determine true-ups • Integration with indirect taxes operationally, e.g., VAT, GST, Medical Excise Tax	Data challenges are: • Obtaining timely and accurate data to enable transfer pricing charges to be calculated • Control environment regarding calculations • Driving execution downstream (e.g., invoicing, settlement, journals) • Performing calculations quickly enough to meet financial 'close' timetable

Because It's Worth It

Pulling together multiple internal functions and going through the discipline of addressing process, personnel, and technology issues in a comprehensive manner can be lengthy and complicated. However, the benefits are undoubtedly worth it—a more effective execution of an organization's transfer pricing strategy and the mitigation of risks. The E2E process also can result in improved communication and overall efficiency throughout the enterprise, which benefits all functions and the organization as a whole. The controllership function, in particular, may recognize a number of positive impacts:

- Technology enhancements may help the transfer pricing team better understand year-end results and more timely and accurately calculate true-up adjustments.
- Agreeing on hand-offs in the business process should lead to efficiency improvements, speed up quarterly closings, and clarify responsibilities and timing.
- Formalized rules and accounting logic should improve understanding of the details of transfer pricing execution for forecasting efforts.
- There may be an opportunity to integrate transfer pricing understanding of intra-group profit with other calculations.

The matters discussed in this article can form a solid foundation on which an enterprise can build a comprehensive E2E process that supports the company's transfer pricing strategy and strengthens its financial position. Looking at transfer pricing as an E2E issue—from transfer pricing strategy all the way through to local level financial statements—assists in mitigating risks inherent in transfer pricing compliance and helps ensure the expected benefits of planning are achieved.

About the author

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