

## Putting intercompany accounting on the straight and narrow

Why ignoring the problem is  
increasing corporate risk

Financial Risk



# Risk powers performance

## Getting serious about intercompany accounting



In recent years we've begun to see more and more companies run into serious difficulties due to a failure to address intercompany accounting issues. It's a problem that many organizations have downplayed, oversimplified, or even ignored. But turning a blind eye can have significant consequences, including hefty fines, financial restatements, and even lawsuits.

A number of trends are converging to make intercompany accounting an even bigger issue for finance executives. Companies are becoming increasingly complex and global in nature. Many have multinational value chains that generate a high volume of intercompany transactions—sometimes dwarfing their external sales many times over. At the same time, greater regulatory scrutiny and a rise in enforcement are exposing companies to more risk.

This publication discusses both a holistic and a proactive approach in which the primary stakeholders—accounting, tax, and treasury—work together to streamline processes ranging from governance to data management to reporting. To be effective they will need a common vision and a framework for getting all the pieces moving in tandem.

Now is the time for companies to re-evaluate their intercompany accounting—doing so will result in streamlined processes, less redundancy, and collaborative working relationships. Such a shift will position them to focus resources on improving performance and fostering growth. Leaders who recognize the opportunity for risk to power performance will go beyond protecting value to creating value. Deloitte's Risk Advisory professionals around the world can help you explore ways to not only address this growing risk, but to power your performance as well.

To learn more, please visit us at [www.deloitte.com/financialrisk](http://www.deloitte.com/financialrisk).

Regards,

A handwritten signature in black ink that reads "Sam". The signature is stylized and appears to be written in a cursive or semi-cursive font.

Sam Balaji  
Global Risk Advisory Business Leader



Intercompany accounting (ICA) refers to the processing and accounting for internal financial activities and events that impact multiple legal entities within a company. ICA can include sales of products and services, fee sharing, cost allocations, royalties, and financing activities. It's a broad area that, while rooted in accounting, has extensions into various functions, including tax, treasury, and finance.



A manufacturing company faces a criminal inquiry involving intercompany cash transfers related to its tax planning.



An insurance company is forced to restate financial results stemming from its failure to eliminate certain intercompany transactions related to variable-interest entities.



A company's weak internal controls over its related-party transactions allows insiders to fraudulently overstate inventory, leading not only to regulatory fines and restrictions, but to two lawsuits.



An oil company's improper intercompany accounting results in a restatement of its financial statements and a subsequent lawsuit accusing it of misleading investors about the effectiveness of its internal controls.

### **Has your organization been turning a blind eye to intercompany accounting?**

The trend is an unsettling one. More and more companies are running into serious problems that have real financial costs as a result of improper or insufficient ICA practices. The reasons range from increased industry consolidation to growing globalization and integrated supply chains. But, in part, the problems are a product of continued denial and neglect. For years, ICA has been downplayed and oversimplified by an “everything nets out” mentality and the issue is simply forgotten. Yet as the consequences intensify, companies are realizing it’s time to straighten things out.

### **Understanding the root of the problem**

Today’s organizations are far more complex than they were a mere decade or so ago. Many have significantly expanded their global footprints, building multinational value chains that generate an enormous volume of intercompany transactions. Operating in multiple countries introduces the need for compliance with country-specific regulations and tax policies. This is especially important given the growing level of regulatory scrutiny from national bodies, particularly in the area of cross-border transactions of multinationals.

ICA has been further complicated by industry consolidation, where stronger players snap up their weaker competitors, often inheriting heterogeneous financial systems, charts of accounts, and accounting processes with each new acquisition. Moreover, as companies grow, they frequently introduce centralized business service centers, which increase the number

of intercompany transactions processed. Today, intercompany transactions for large multinational corporations can dwarf their external sales, sometimes many times over.

Companies also face a host of other pressures that have them scrambling to find better ways to address this escalating problem. The global proliferation of accounting and tax regulations has been accompanied by a rise in enforcement, exposing companies to greater risk if they fail to streamline their intercompany transactions. They are also under the gun to achieve a more efficient financial close in order to support filing deadlines and internal control assertions.

In short, the challenges of performing effective and efficient ICA are substantial. Companies grappling with myriad incompatible financial systems and inconsistent processes are often forced to use detective, “after the fact” methods to try to catch the errors. These quick-fix tactics only postpone the inevitable—and the problem keeps growing. Leading companies are evolving their approach and taking a preventive stance in which the primary stakeholders—accounting, tax and treasury—work hand in hand to create an ICA framework that is streamlined, from governance to reporting.

### **No function is an island**

Taking a collaborative approach is step one in cleaning up the ICA missteps of the past. The effects of improper ICA extend beyond the accounting function, a fact that may not be fully appreciated in many organizations. For example, a company may succeed at eliminating intercompany

accounts receivable and accounts payable transactions from their books (within a specific tolerance threshold), thus achieving an important financial reporting goal. Yet at the legal-entity level, exceptions and misclassifications may still remain—with certain tax implications. If addressing a particular issue for the accounting department has negative repercussions for the tax department, the ICA problem is just getting redistributed, but not actually resolved.

### **Three major functions impacted by ICA:**

**Accounting:** The accounting function is focused on financial accounting and reporting. The primary risk of improper ICA for accounting is financial misstatements, which can impact the company’s reputation, stock price, and shareholder value. Visibility and traceability of ICA transactions are key problem areas, particularly when intercompany settlements are via email exchanges with spreadsheet attachments. When taking into account the volume of transactions and the requisite audit trails, the risks of non-compliance with regulatory bodies grows with each transaction.

Furthermore, weaknesses in internal controls may surface during an audit, since regulatory bodies, such as the Public Company Accounting Oversight Board, have been revising and tightening relevant standards covering related-party transaction and the audit requirements for related parties. Finally, insufficient ICA transparency and control provide the opportunity for misappropriation of assets, allowing unscrupulous professionals to hide assets flowing out of the organization to fictitious vendors or accounts.

**Tax:** The tax function focuses on the financial positions of individual legal entities. Transactions between countries are subject to specific tax laws and transfer pricing requirements. Misclassified profits between countries can result in tax penalties, interest, and reputational damage. Tax organizations of large multinationals have been particularly impacted by the requirements of the Base Erosion and Profit Shifting (BEPS) project, developed by the Organisation for Economic Co-operation and Development and the G20. The BEPS project was initiated in 2013 as a way to enable the automatic sharing of company tax information on a country-by-country basis. The final reports were issued in October 2015 and the main text on the Multi-Lateral Instrument agreed in November 2016 and formally signed in June 2017 by an initial 70 jurisdictions. The goal of the BEPS requirements is for companies to present transparent and well-governed financial statements and documentation for individual countries so that regulators and tax authorities can easily identify each country's standalone financials and conduct transfer-pricing risk assessments. As national bodies focus their attention on corporate tax-avoidance strategies, it becomes increasingly important for organizations to have a strong ICA strategy designed to eliminate discrepancies between legal entities and support accurate country-by-country reporting.

**Treasury:** The treasury organization receives details of intercompany trade transactions and manages the netting and settlement of intercompany trade invoices. It also manages intercompany financing and global liquidity and foreign exchange (FX) exposures. When ICA is unable to deliver a full list of approved intercompany balances for settlement, a trade imbalance will persist, impacting intercompany liquidity. ICA in this case becomes not just a liquidity

issue; it also impacts FX. Unresolved intercompany positions may cause unrealized gains and losses for accounting purposes, but real cash outflows from a tax perspective.

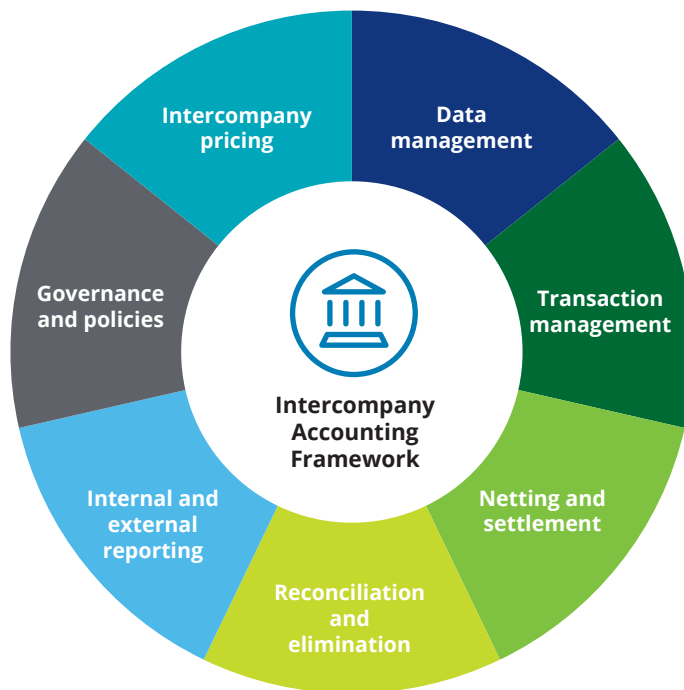
One of the greatest issues facing ICA settlement is the institutional knowledge needed to clean up the historical unreconciled balances. As time goes by and people move, or as companies undergo mergers and acquisitions, it's often extremely hard to close these out, especially when the issues have persisted for years.

### Establishing a vision and a framework

Getting everyone working from the same playbook and equipping them to straighten out ICA calls for a single vision for the future. To describe that future, a company will first need a framework that provides a holistic perspective and incorporates every aspect of ICA, from governance to reporting. The advantage of a framework is that it can help visualize ICA as an interconnected, interdependent, end-to-end process while breaking it down into manageable pieces. Then, to address each component of the process, a company needs an approach that embeds both leading practices and a roadmap for adopting them.

Getting everyone working from the same playbook and equipping them to straighten out ICA calls for a single vision for the future ... a framework that provides a holistic perspective and incorporates every aspect of ICA from governance to reporting.

Deloitte Risk Advisory uses a framework that is divided into seven components representing the relevant accounting, treasury, tax, legal, and business considerations associated with intercompany transactions.



Based on extensive industry experience working with ICA in a wide range of companies globally, Deloitte Risk Advisory has identified a set of leading practices for each component of this framework. These practices seek to address the common challenges of ICA, including insufficient or poor use of technology, non-standardized processes, and difficulties with transaction matching and account reconciliation.

**Governance and policies:** Effective ICA begins with standard global policies governing critical areas, such as data and charts of accounts, transfer pricing, and allocation methods. Leading companies establish a center of excellence with joint oversight from accounting, tax, and treasury that serves as a resource to address global process standardization and ICA issues. Trade/service agreements are in place, with clearly defined and communicated roles and responsibilities.

**Intercompany pricing:** Leaders in this area have adopted a global pricing policy and have integrated transaction-level pricing and analytics. Tax and finance functions are tightly integrated, working together to determine appropriate arm’s-length pricing.

**Data management:** Master data is managed by a center of excellence to address tax, business, and accounting requirements. There is an integrated transaction flow across platforms with common charts of accounts, supported by integrated reporting capabilities that meet tax, statutory, and finance requirements. Trading partners are clearly identified and controlled, allowing transactions to be isolated for eliminations and reporting.

**Transaction management:** ICA transactions are inventoried and categorized by type. Workflow and procedures are standardized by transaction type to facilitate efficient processing and provide a normalized reporting capability. Transactions between legal entities incorporate technology-enabled approval

routing and dispute resolution. Corporate allocations and centralized service charges follow standard methods and use standard calculation vehicles to ensure consistency and efficient processing. Finally, materiality is often used to rationalize transaction volume.

**Netting and settlement:** Netting and settlement are critical for the treasury function. To achieve effectiveness in these areas, companies need multilateral settlement based on a defined cash management strategy. Leading practices also include automated, dynamic settlement with clearing of originating transactions on the local ledgers and a strategy that defines when settlements require cash transactions versus accounting entries.

**Reconciliation and elimination:** This is generally the most time-consuming and resource-intensive area for the accounting function, particularly when there are insufficient preventive controls in place. Companies with advanced intercompany processes have fully automated transaction-level matching, reconciliation, and elimination, including clearing of original balances post-settlement.



**Internal and external reporting:** Reporting is important to all three functions. Companies that excel in this area have systems with automated, integrated financial, tax, statutory, and regulatory reporting and analytics. These systems also offer dashboard visibility into customized performance metrics that require minimal manual intervention.

Despite the emphasis on systems that automate and integrate ICA processes, technology alone is not the answer. Even with sophisticated enterprise resource planning landscapes supported by highly capable financial systems, ICA was never a core element of their design. Designing an approach that is cross-functional, assigns ownership and accountability, and is based on well-delineated processes is critical to the success of ICA initiatives.

### Solving the problem... once and for all

Countless organizations struggle with the time-intensive requirements of managing an ICA program that is often inefficient due to processes and systems that have been pieced together and neglected over time. But denial will only lead to growing disarray and serious risk exposures. As the complexity of ICA continues to rise and the consequences for getting it wrong become increasingly apparent, financial executives need a strong and fresh approach to this long-ignored problem.

## Global contacts



**Vishal Vedi**  
Global Financial Risk Leader  
Deloitte LLP  
+44 20 7303 6737  
vvedi@deloitte.co.uk



**Craig Vink**  
Partner  
Deloitte LLP  
+44 118 322 2238  
cvink@deloitte.co.uk



**Anthony Waelter**  
Partner  
Deloitte & Touche LLP  
+1 312 486 5519  
awaelter@deloitte.com

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Source: IDC MarketScape: Worldwide Risk Consulting Services 2017 Vendor Assessment by Cushing Anderson, July 2017

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