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Operational transfer pricing
Enhancing insight and process management through technology

Multinational corporate tax departments often encounter inconsistent transfer pricing data from business units around the world, dramatically increasing complexity and staff workload, not to mention the potential for quarter- or year-end surprises. How can new tools and processes help tax departments overcome data and process issues?

Deloitte hosted a Dbriefs webcast, to discuss the evolving and increasingly important concept of operational transfer pricing. Presenters discussed the current transfer pricing environment and issues, financial system considerations, and ways to complement existing financial system capabilities. More than 1700 participants shared their own views through responses to polling questions posed during the webcast.

Current environment elevates the need for operational transfer pricing

Tax authorities around the world, as well as groups such as the Organisation for Economic Co-operation and Development (OECD), are issuing increasing amount of guidance in areas that affect transfer pricing. For example:

- *The OECD Discussion Draft on Intangibles* proposes a very broad definition of intangibles that could be subject to interpretation and potential controversy when defining and valuing brand names, customer intangibles, and other intellectual property.
- *The OECD White Paper on Documentation* focuses on country-by-country reporting requirements that could create a significant compliance burden for taxpayers in the absence of an automation solution.
- *The OECD Transfer Pricing Risk Assessment Handbook,* issued in April 2013, encourages early collaboration between tax administrations and taxpayers to avoid protracted transfer pricing disputes. It also provides insight into selecting transfer pricing issues for audit and discusses the exchange of information under tax treaties between governments.

The "BEPS" report: One notable development is the OECD Base Erosion and Profit Sharing (BEPS) project launched in 2012 in response to growing perceptions that governments lose substantial corporate tax revenues. A February 2013 report discussed the perceived magnitude of BEPS and provided an overview of the global developments that have an impact on corporate tax matters. It also suggested that current international tax standards may not have kept pace with changes in the global business practices and promised an action plan, which the OECD issued five months later. This was quickly followed by the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, which provides some very clear parallels with the BEPS action plan. The exhibit below describes five particular proposed actions relevant to transfer pricing.

BEPS = More controversy?

Action Item	Description	Timing
Actions 8, 9, and 10 — Assure that transfer pricing outcomes are in line with value creation	• Develop rules with respect to intellectual property. • Develop rules that do not assign benefits solely to contractually assumed risks or provided capital. • Restrict benefits of transactions that would not occur between third parties.	September 2014, September 2015
Action 11 — Establish methodologies to collect and analyze data on BEPS	• Identify whether BEPS is occurring and if so, to what extent is it occurring.	September 2015
Action 13 — Re-examine transfer pricing documentation	• Design rules that require multinational entities to provide all relevant governments with information on their global allocation of income, economic activity, and taxes paid among countries.	September 2014

These action items propose development of rules for the perceived base erosion transactions, but country tax authorities may have very different views about what constitutes base erosion. Ultimately, these differences of opinion could lead to additional controversy and risk of double taxation until more multilateral decisions and agreements are reached — providing more impetus for companies to revisit operational transfer pricing now.

An integrated operational transfer pricing approach

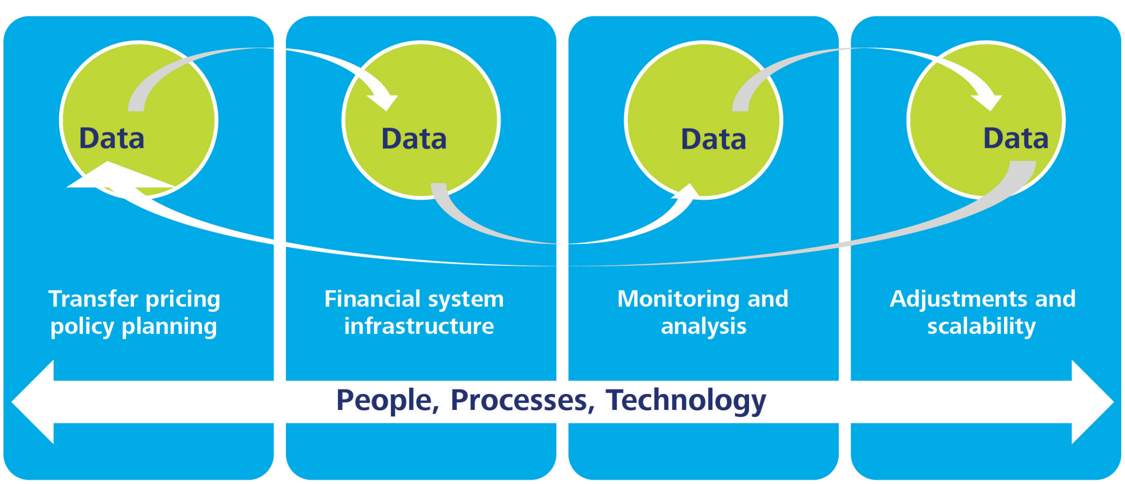
For many years, companies have grappled with the concept of operational transfer pricing — the application of data management and analytics solutions for overcoming inconsistent transfer pricing data and process issues, and enabling effective and continuous implementation and monitoring of transfer pricing policies organization-wide. The graphic below depicts an integrated operational transfer pricing process.

Integrated operational transfer pricing benefits an array of companies, including those with:

- Significant intercompany transactions.
- Inconsistent or unpredictable transfer pricing results that make it difficult to forecast effective tax rate (ETR).
- Inability to regularly monitor transfer pricing results on a global basis.
- A history of year-end transfer pricing adjustments and/or difficult audits due to transfer pricing issues.
- Delays in the accounting close process due to intercompany accounting.
- Difficulty producing segmented financial information for transfer pricing purposes.
- Burdensome data sourcing requirements.
- Non-centralized accountability for transfer pricing.
- Lack of documentation in relation to transfer pricing controls and processes.
- Multiple enterprise resource planning (ERP)/financial systems in use across the business.
- New ERP systems.
- Manual, spreadsheet-based processes for calculating transfer pricing.

The remainder of this article looks at leading practices and developments relevant to the four key elements of integrated operational transfer pricing.

Integrated operational transfer pricing process



Transfer pricing policy planning

Planning is critical to avoid inadequate or inconsistent implementation of transfer pricing policies, which can lead to a variety of issues — for example, misstated financial statements or large post-year-end transfer pricing adjustments that may increase the possibility of double taxation, tax penalties, and/or audits. Prolonged tax-dispute scenarios can also create significant management disruption and affect corporate reputation.

Transfer pricing is the heart of intercompany transactions and can have significant consequences if done incorrectly.

There are four pillars of effective operational transfer pricing planning:

- A global transfer pricing policy that is supported by appropriate economic analyses and consistent with the functions, risks, assets, and intellectual property of the underlying companies.
- Intercompany agreements between relevant legal entities that are aligned with the substance of the transactions in order to mitigate the risks of re-characterization.
- A global governance model, analytics, and monitoring process that determine and facilitate policy compliance and consistency.
- Contemporaneous transfer pricing documentation that demonstrates that policies have been established and implemented in a way that allows the company to achieve "arm's length" results at the end of the year.

Financial system functionality and infrastructure

The core challenge in this area is that two often disparate needs have to be addressed out of one financial system landscape.

- Management needs focus more on a global and perhaps divisional or serviceline reporting.
- Statutory, legal, tax, and local country accounting needs are much more aligned with the organizations' legal entity structure and geographic borders.

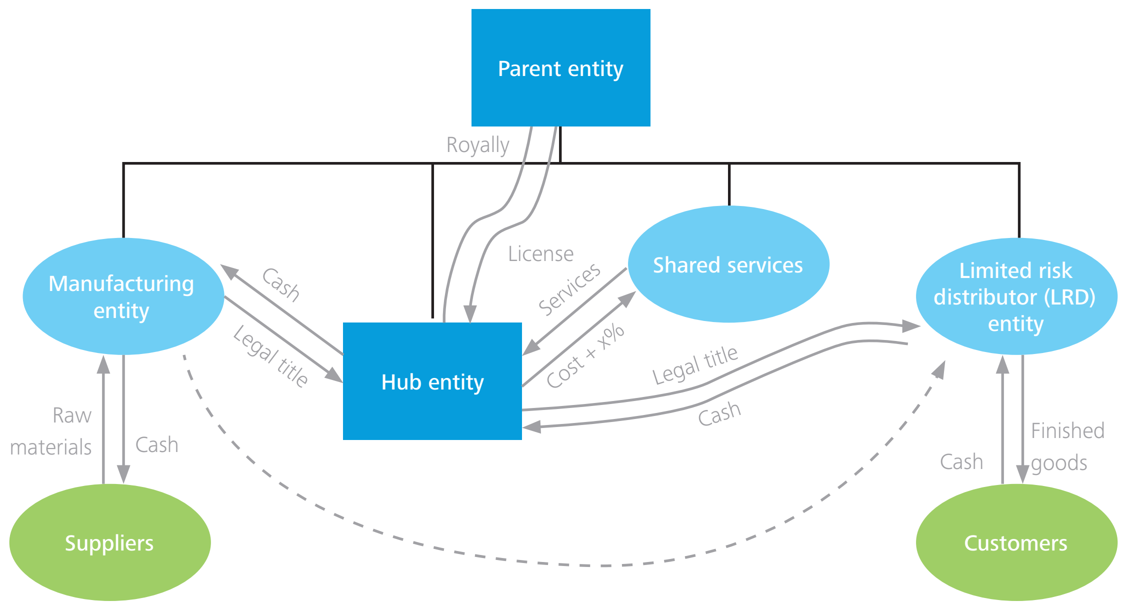
Today an organization's systems and infrastructure must support both groups, and the intercompany transaction has developed into one of the most prominent reasons for this. Transfer pricing is the heart of intercompany transactions and can have significant consequences if done incorrectly. As the legal transactional "system of record," the financial system must contemporaneously address the impact of intercompany accounting and transactions on various requirements, including proper invoice form and formatting as per country laws; proper "arm's length" pricing; logistics, shipping, and freight; customs and duties; transactional taxes (value added tax (VAT), goods and services tax (GST)/provincial sales taxes (PSTs), sales and use tax, etc.); and withholding taxes.

If the transfer price is wrong, then each of these areas has a high potential to be incorrect as well. Additionally, a transfer price can create other potential conflicts with management reporting, including poor visibility to profit in inventory, site performance, and key performance indicators (KPIs). If an organization is able to get to a point where a strong transfer pricing mechanism is in place, they will find they may be able to create a more level playing field to judge operations globally.

Global operating models: As the barriers to global trade have significantly diminished, many global organizations are evolving to more of a hub and spoke business model (depicted in the exhibit on the next page) that can allow for significant global operating efficiencies for many different aspects of the business due to:

- Co-location of decision makers.
- Centralized approaches to key processes and flows such as transfer price management or intercompany settlement.
- Centralized management of working capital and sourcing.
- Greater control throughout the supply chain and supporting transactions.
- Specialized legal entities with distinct functions, substance, and risk management.

Aligning financial systems with your operating model



While a hub and spoke like operating model does provide for very significant global operating efficiencies, it does create extreme intercompany complexity.

Substance aligned with financial system transactional detail: As government revenue shortfalls climb, more and more jurisdictions are intensifying efforts to claim their fair share of revenue from companies operating within their borders. Two significant and recent developments enable government authorities to examine how companies account for intercompany transactions and to make sure that such transactions are occurring in a manner consistent with stated positions.

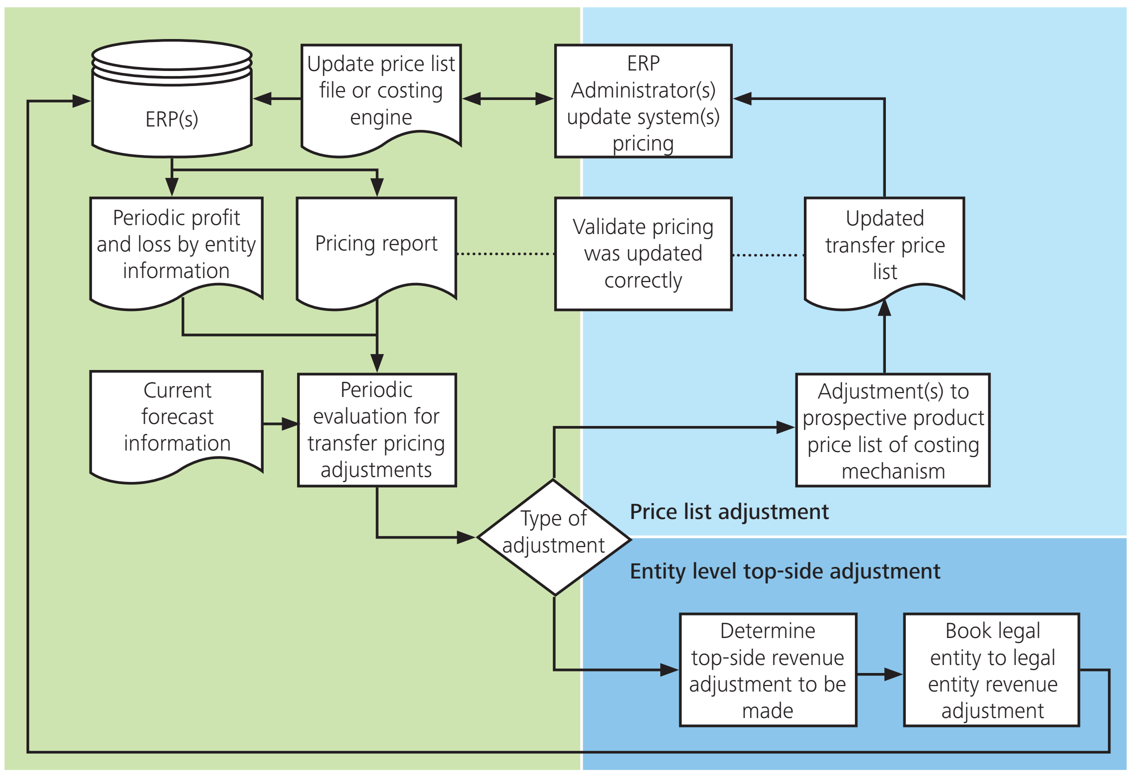
- The move toward electronic filing requirements and data requests.
- The ability to use analytical procedures on top of electronic file extracts.

A pioneer in this area, Brazil, requires companies to share information electronically by connecting to the government system. Today governments are evaluating how they can accomplish the same level of access and one solution is to require a full extract of transactional system detail. While the OECD is issuing and further developing guidance in this area, it is important to recognize that a country can go much further at its own discretion. For example, recently enacted regulations in France require more information around transfer pricing policy than specified in current OECD guidance such as:

- A mandatory standard audit file for tax (SAF-T) that records key information in a specified common format for audit purposes, including data related to general ledger, accounts receivable, accounts payable, fixed assets, and inventory. This new requirement will put pressure on the audit trail during examination, as the SAF-T must align with transfer pricing documentation and internal controls.
- They do not include a materiality threshold.
- They allow the taxing authority to request a French translation of documentation.

The exhibit below depicts a conceptual data flow that supports operational transfer pricing by enabling contemporaneous price adjustments as markets fluctuate. Recognizing that most companies do not have a single global ERP instance as shown in this example, they do still have the ability to harmonize their data structure and utilize analytical tools to accomplish this within their overall financial systems landscape.

Conceptual transfer pricing process

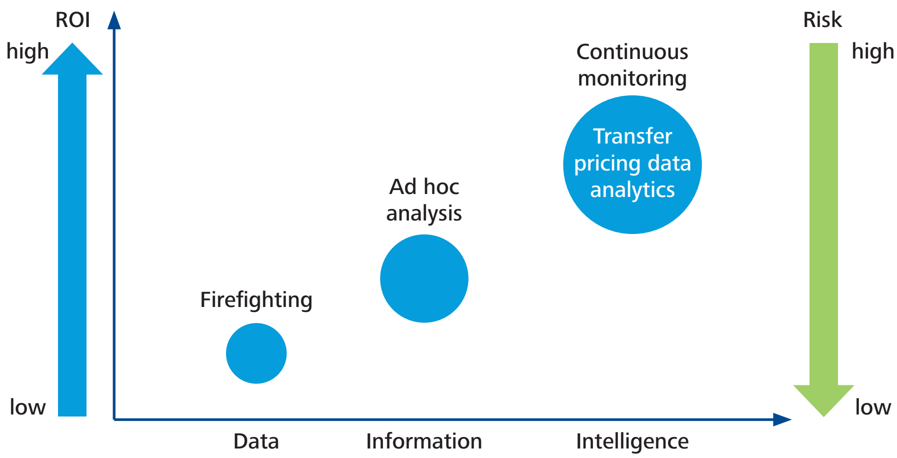


Monitoring and analysis

For many companies, the primary focus on consolidated reporting from a global standpoint creates a view that intercompany transactions and transfer pricing is not as critical of an area of focus — but things break down when they start looking at it from a local level. Processes, technology, and leading practices can help bridge this gap. Effective use of data analytics turns data into intelligence, which assists in decision making, improves accounting integrity on a transactional basis, and enables a more complete transfer pricing review.

One way to look at monitoring and analysis capabilities is as a continuum, depicted in the exhibit on the next page, where risk and return on investment (ROI) work in opposite directions. At one end is a "firefighting" approach, where the monitoring and analysis function is only performed after a potential issue has been identified. This approach increases risk, without providing a high return on investment, since it is more reactive and ad hoc in its application. At the other end of the continuum is a continuous and proactive monitoring approach with transfer pricing-specific data analytics that run throughout the year. In our experience, most companies fall somewhere between firefighting and ad hoc analysis — addressing it only when they have to or only monitoring a few selected jurisdictions regularly because of previous issues.

Performance continuum



Adjustments and scalability

Given the constantly changing data, technology, and transfer pricing landscape, "scalability" is critical when implementing operational transfer pricing solutions. After all, you want to build something that can grow and accommodate future changes and complexities. Several factors are fundamental to scalability.

At the top of the list is *data management*. Most companies spend around 80 percent of their time compiling data and only about 20 percent analyzing it. Technology can accelerate these steps and reduce manual data manipulation, which not only mitigates the risk of human error but also frees staff for higher-value work. A good starting point is to identify existing data sources and systems and understand how to extract data from them. Third-party systems can help where existing enterprise systems don't adequately support efficient and effective operational transfer pricing practices.

Implementation of operational transfer pricing tools should focus on standardizing, automating, and implementing transfer pricing as much as possible in day-to-day operations. Ideally, everyone around the world, no matter who has responsibility for transfer pricing, should use the same set of tools to leverage the same body of data to perform the same types of analytics, while maintaining flexibility to account for specific jurisdictional dynamics.

Monitoring should provide end-to-end supply chain transparency and visibility across country, business group, transaction, and particularly stock-keeping unit (SKU) level data. Systems should enable real-time, continuous, and centralized monitoring for all entities and transactions, allowing entities to make continuous fixes in the application rather than always having to fix it "at the end." Finally, a scalable solution should confirm that transfer pricing results reflects both company policies and local country regulations.

Lastly, given the heightened global scrutiny, demonstrating active compliance is where the "rubber meets the road." A scalable solution enables a company to identify transfer pricing risks, determine transfer pricing adjustments, and avoid indirect tax issues and large year-end adjustments — steps that demonstrate a proactive rather than reactive approach. It also helps create appropriate audit trails and manage audits globally.

A scalable technology solution can generate other operational transfer pricing benefits, including the ability to:

- Control transfer pricing position and identify quick wins, planning opportunities, anomalies, trends, and risks.
- Analyze transfer pricing policies for individual transactions that can improve cash flow and correct misclassified costs.
- Monitor global tax burden and conduct scenario planning when restructuring transactions.
- Integrate analysis of various taxes (e.g., VAT, GST, and customs).
- Assess the "as-is" environment against leading practices.
- Design and implement new processes and controls.
- Identify day-to-day accounting calculation requirements.

In conclusion, the concept of operational transfer pricing is not new, but it's an exciting and evolving space largely because of how today's technology can help tax departments overcome the inconsistent transfer pricing data and process issues that have frustrated and challenged many over the years.

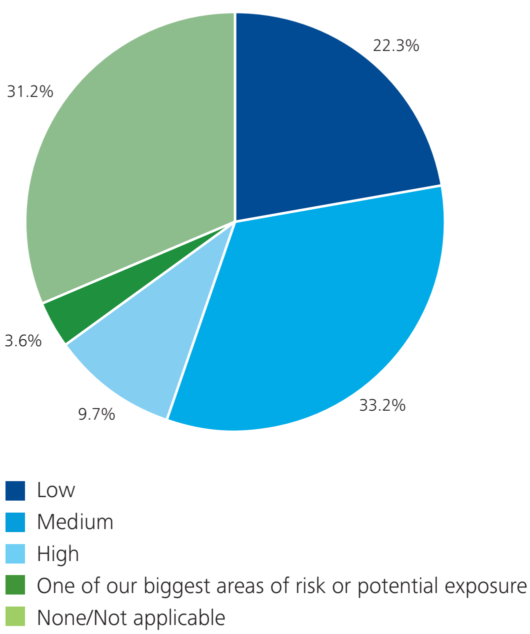
Tax executives' perspective

Deloitte hosted a Dbriefs webcast, to discuss the evolving and increasingly important concept of operational transfer pricing. Presenters discussed the current transfer pricing environment and issues, financial system considerations, and ways to complement existing financial system capabilities. More than 1700 participants shared their own views through responses to polling questions posed during the webcast.

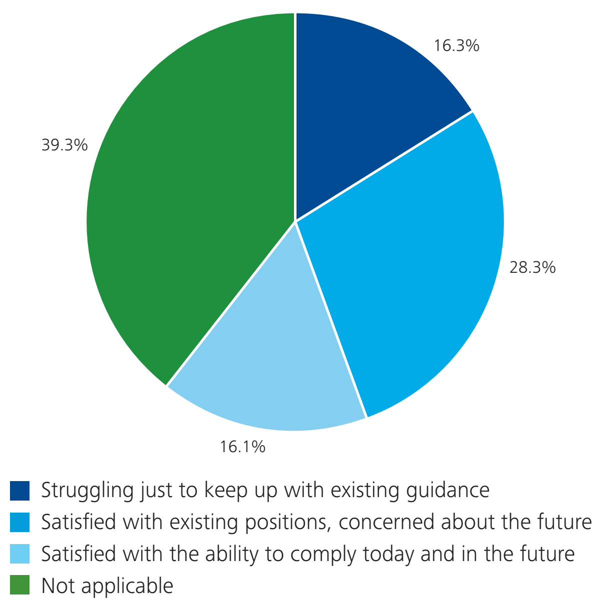
New transfer pricing developments, such as country-by-country reporting requirements proposed by the OECD, could increase compliance burdens and risks. Less than a quarter of webcast participants — 22 percent — consider their companies' risk or potential exposure to transfer pricing issues to be "low." One-third characterized their risk/exposure to be "medium," while 10 percent said it is "high." Four percent believe transfer pricing issues are one of their companies' biggest areas of risk or potential exposure.

In terms of preparedness for increased guidance and new transfer pricing requirements, just 16 percent of participants said they are satisfied with their company's ability to comply today and in the future. On the other hand, 28 percent said they are satisfied with their preparedness to comply today but concerned about the future. Another 16 percent said they are struggling just to keep up with current guidance.

What is your assessment of your company's risk or potential exposure related to transfer pricing issues?



How prepared is your company to comply with the increased amount of guidance and transfer pricing requirements?

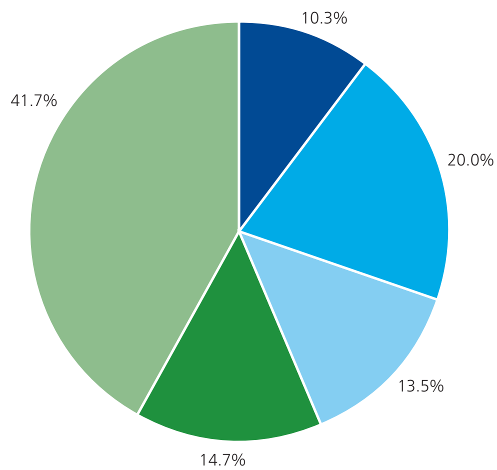


Source: Deloitte's Tax Operations Dbriefs webcast, "Operational Transfer Pricing: Enhancing Insight and Process Management through Technology," held on October 17, 2013. Polling results presented herein are solely the thoughts and opinions of survey participants and are not necessarily representative of the total population.

More and more, authorities want companies to adjust transfer pricing periodically or throughout the year. Indeed, 10 percent of webcast participants said their companies do review and adjust pricing detail throughout the year. Twenty percent set pricing for the year and then make adjustments periodically during the year. Only 13 percent set pricing at the beginning of the year and then make a large adjustment at year end. About 15 percent said they do not have a standard approach to adjustments.

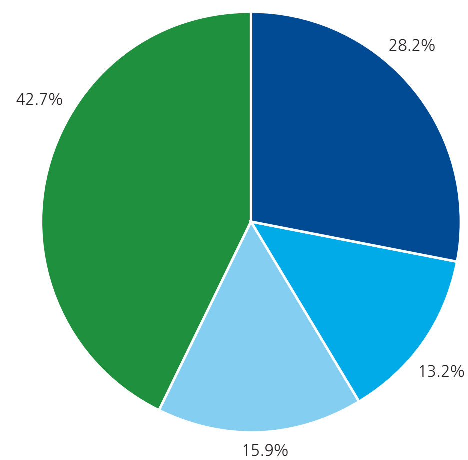
From an analytics and monitoring standpoint, a centralized approach ensures that everyone is using the same tools and data to perform transfer pricing analyses. Twenty-eight percent of webcast participants said their transfer pricing monitoring approach is "highly centralized," while 16 percent said it is "both highly centralized and decentralized." Only 13 percent characterized their transfer pricing monitoring approach as "decentralized."

What statement does your pricing strategy most align with?



- We review and adjust detail pricing throughout the year
- We set pricing for the year and make adjustments periodically during the year
- We set pricing at the beginning of the year and just make large year-end adjustments
- We do not have a standard approach
- Not applicable

Is your transfer pricing monitoring?



- Highly centralized
- Decentralized
- Both highly centralized and decentralized
- Not applicable

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