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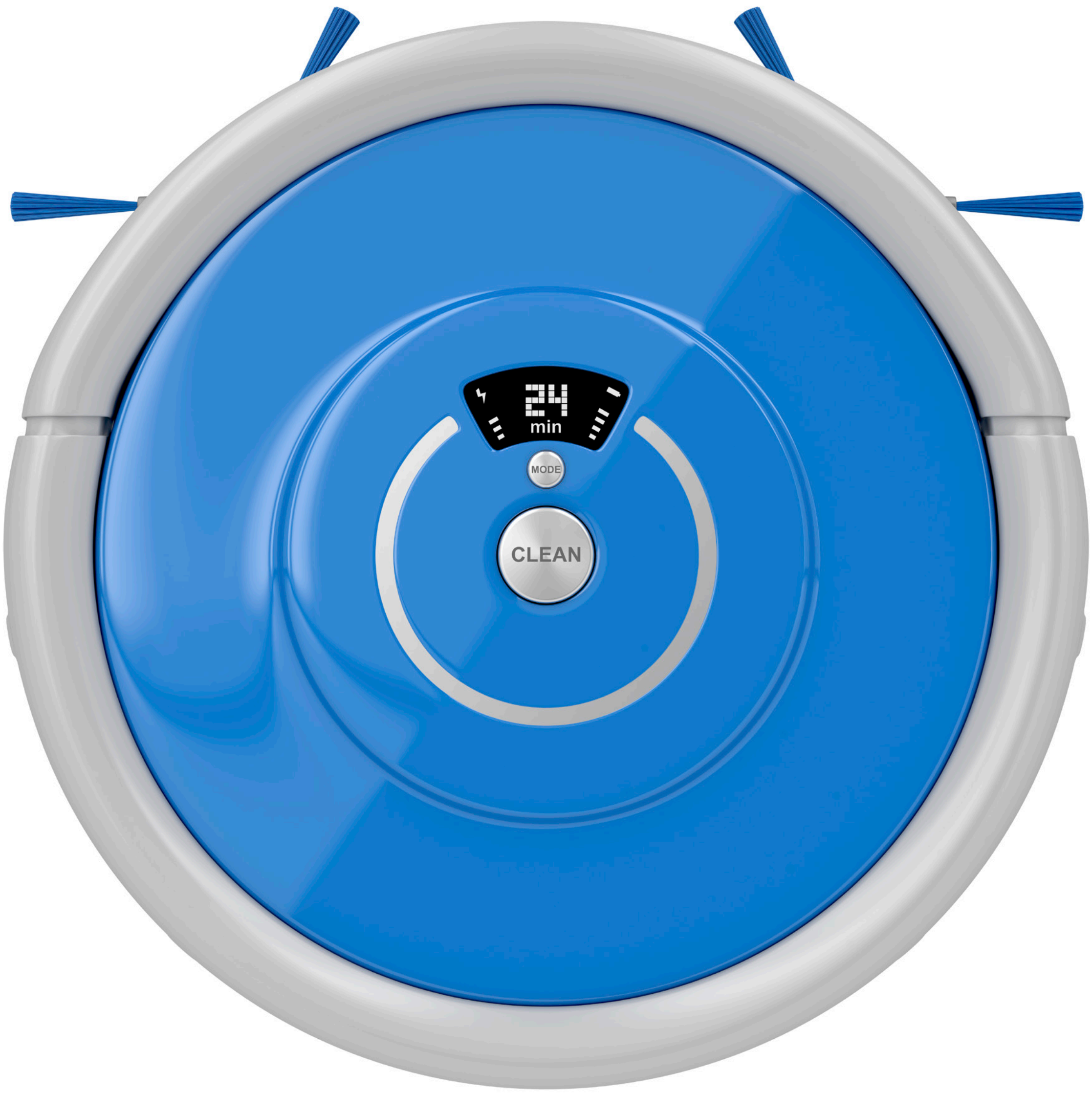

Cleaning up the mess under the bed

Why intercompany accounting is increasing corporate risk

What is intercompany accounting?

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 federal grand-jury investigation 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 Securities and Exchange Commission-imposed fines 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.

What's under your organization's bed?

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 intercompany accounting 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 swept under the bed. Yet as the consequences intensify, companies are realizing it's time to address the mess.

Understanding the root of the problem

Today's organizations are far more complex than they were a mere decade or so ago. They also face increased competition on the one hand and greater regulatory scrutiny on the other. Many companies have significantly expanded their global footprints, creating multinational value chains that generate an enormous volume of intercompany transactions. Operating in multiple countries also introduces the need for compliance with country-specific regulations and tax policies.

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 by as much as a factor of 10 or more. In fact, according to a report by the United Nations Conference on Trade and Development, some 80 percent of global trade takes place within the value chains of large global organizations.[1]

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 band-aid tactics only postpone the inevitable—and the mess keeps growing. What companies need is a holistic and preventive approach in which the primary stakeholders—accounting, tax, and treasury—work hand in hand to create a vision for the future that streamlines ICA, 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 specific issue for the accounting department has negative repercussions for the tax department, the mess under the bed may get shuffled around but not cleaned up.

There are 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. Weaknesses in internal controls may surface during an audit, particularly since the Public Company Accounting Oversight Board has revised and tightened AS 18, the standard covering auditing 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.

1*World Investment Report 2013: Global Value Chains: Investment and Trade for Development*, United Nations Conference on Trade and Development.

Tax: The tax function focuses on the financial positions of individual legal entities. Transactions between countries are subject to specific tax laws. Misclassified profits between countries can result in tax penalties, interest, and reputational damage. Tax organizations of large multinationals have been particularly impacted by new requirements for country-by-country reporting in the European Union. This legislation, based on the guidelines from the Organisation for Economic Co-operation and Development's Base Erosion and Profit Shifting project, stipulates that the ultimate parent entity of a multinational group set out global data by country for its fiscal year in a prescribed template, together with a list of entities by country of residence and an indication of their activities. The goal of these requirements is for companies to present financial statements that are transparent and well-governed for individual countries, allowing regulators to easily identify the standalone financials in each respective country. Intercompany discrepancies between in-country legal entities must be reconciled and remediated in order to 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.

Getting out the broom and dustpan

Getting everyone working from the same playbook and equipping them to clean up the ICA mess 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.

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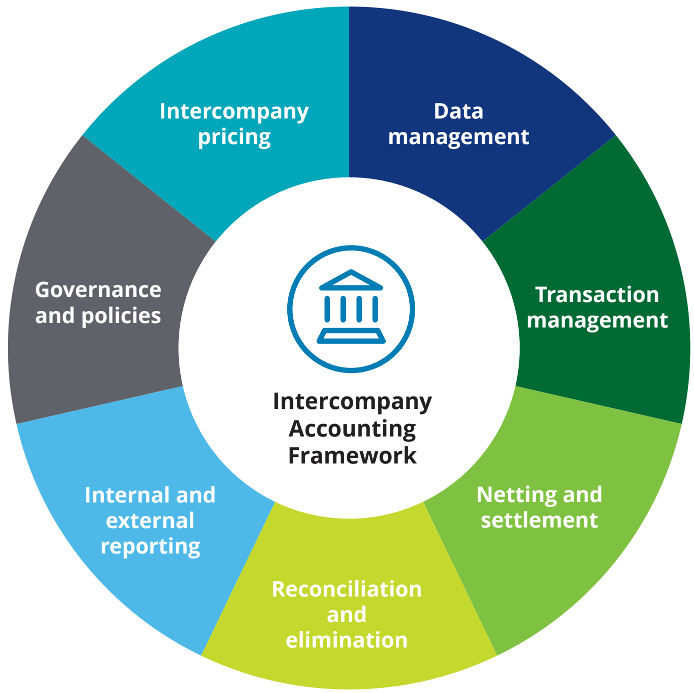
Deloitte Advisory uses a framework that is divided into seven components representing the relevant accounting, treasury, tax, legal, and business considerations associated with intercompany transactions.



Based on extensive research of ICA practices in a wide range of companies, Deloitte 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.

Cleaning up the mess: Now is the time

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 a growing mess, including 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. The time has come to clean up the mess under the bed.

Contact Deloitte Advisory

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