Peters Advisors
TRANSFER PRICING • TAX VALUATION

The Importance of Operational Transfer Pricing

Presentation to TEI, NJ Chapter

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DRAFT
For Discussion Purposes Only

The Transfer Pricing Process

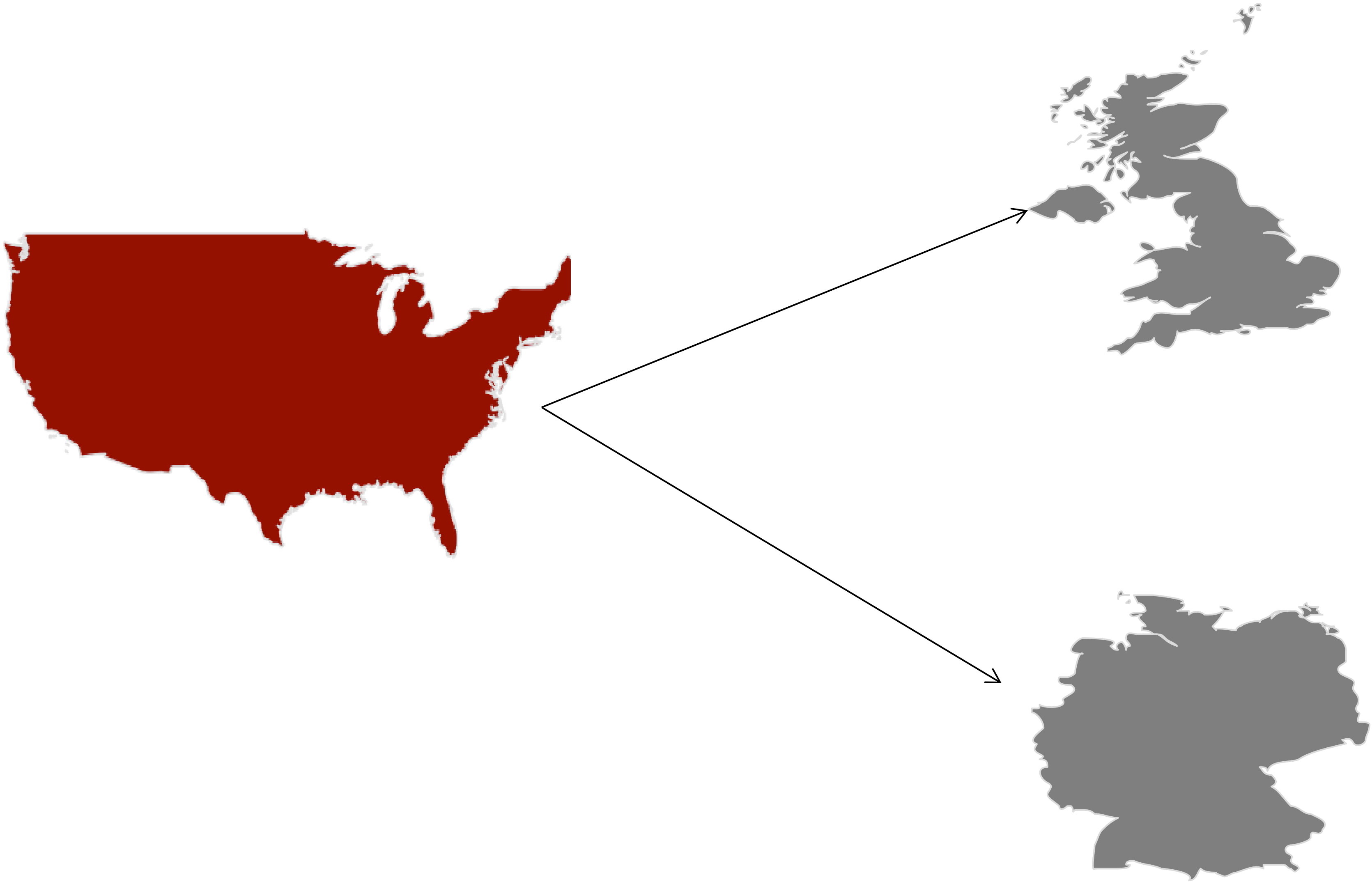
For most companies, managing the transfer pricing process was typically done on an ad hoc basis

- The two primary steps in this process were setting the intercompany prices for the upcoming year, then preparing documentation after the year was completed
  - Prices would typically be set for the year based on either a) an estimate of overall forecasted margins for the year; or b) that's what we've always done
- As a result of documentation requirements, taxpayers would scramble to gather the necessary information to meet deadlines, usually no earlier than 3 or 4 months past financial close of the year
- Gathering data was an informal, information request driven process, often relying on different people within the company to provide information from one year to the next, with data coming in in different formats and in varying stages of completeness
- With the advent of FIN48 requirements, the timeframe of the process became more compressed, generally requiring a review of results 4-5 days after close, but this generally did not improve the end-to-end process

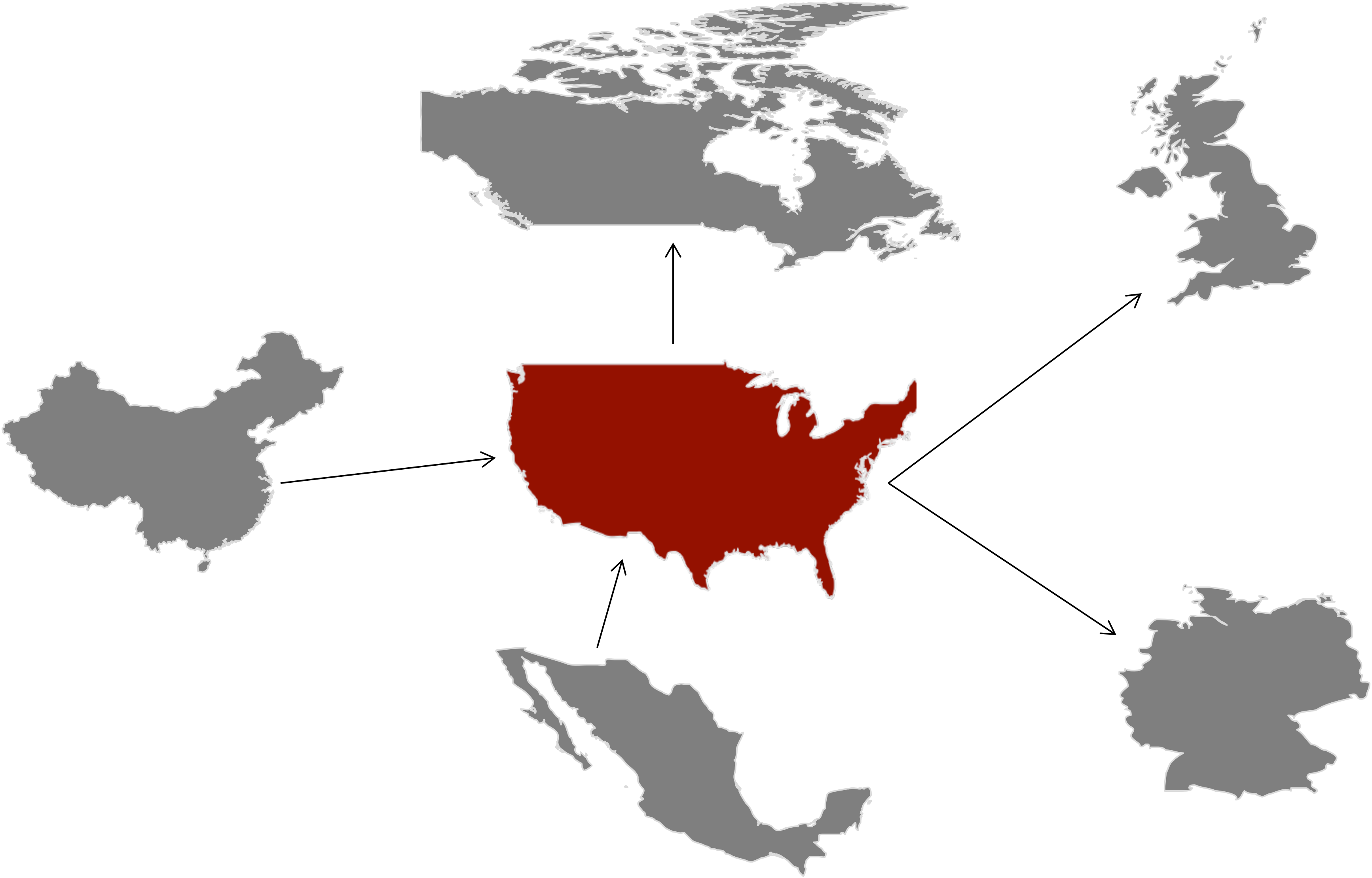
Given the importance of transfer pricing in limiting double taxation risk, preventing contentious audits, determining reserves, and efficiently managing ETR and cash taxes, such an ad hoc approach is becoming less acceptable

- Tax and financial auditors are expecting processes for all aspects of intercompany transactions – setting prices, sending invoices, monitoring outcomes, and documenting results to be more stable and well governed

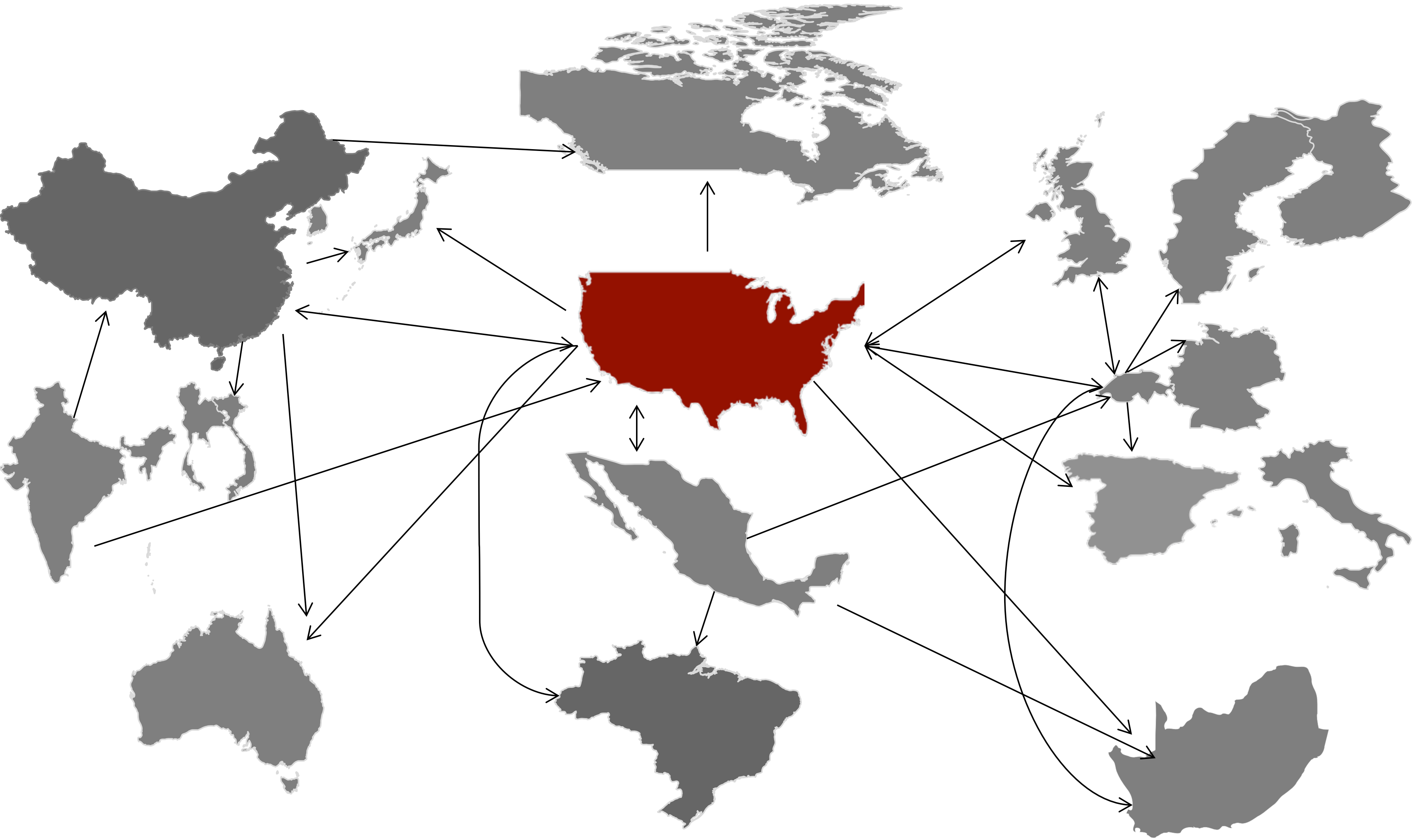
Simple Transfer Pricing Structure



Complicated Transfer Pricing Structure



Complex Transfer Pricing Structure



Challenges of Transfer Pricing Execution

Systems

- Company financial systems are not designed to produce reports necessary for transfer pricing analysis
- Multiple global systems
- Different standards for calculating profit level indicators used in transfer pricing (e.g. operating margin, mark-up on costs)
- Certain systems not designed to handle variances

Implementation

- Often a gap between setting policy and actual implementation – how does a stated TP policy actually apply to product, service, or intangible prices?
- How is pricing input into financial systems?
- Ensuring form of transactions matches the intercompany agreements
- Requires global coordination of different stakeholders in different parts of the business

Challenges of Transfer Pricing Execution

Maintenance

- Ensuring that transactional transfer prices are leading to the appropriate results
- Internal control issues
- Accessing the relevant data to undertake meaningful analysis

Compliance

- Efficiently gathering the necessary information to make period-end adjustments
- Efficiently gathering the necessary information to prepare transfer pricing documentation
- Poorly defined ownership and accountability relating to resolving transfer pricing issues
- Reporting processes are often manual and time-consuming

Planning

- Lack of relevant data to make strategic planning decisions
- Lack of available time to spend thinking proactively

Risks of Incomplete Transfer Pricing

Tax Audit Risk

- Non-compliance with tax audit requirements
- Inability to produce necessary supporting documentation
- Incorrect transfer pricing increases likelihood of audits and income adjustments

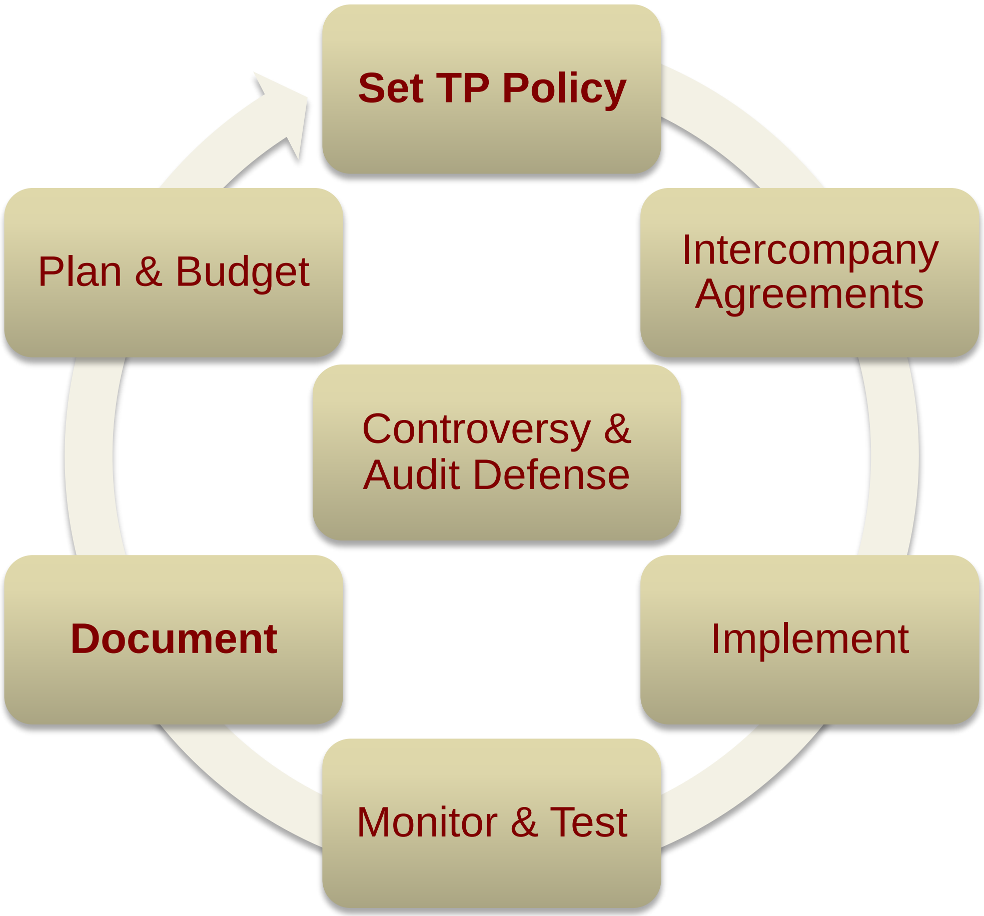
Financial Reporting Risk

- Inaccurate entity-by-entity financial reporting
- Inaccurate regulatory reporting
- Lack of sufficient controls
- Inability to properly quantify transfer pricing risks for financial reporting purposes

ETR and Cash Tax Risk

- Paying unnecessary income taxes due to inaccurate financial results
- Paying excess customs duties, withholding taxes, etc.

What is Operational Transfer Pricing?



End-to-end implementation of transfer pricing policies, monitoring of results, and compliance documentation

Industry Insights & Trends

In 2011, Ernst & Young conducted a survey of over 200 finance and tax executives of Fortune Global 500 and Forbes Global 2000 companies

Global trends and best practices in operational transfer pricing

- Global consistency, centralized management, control, and governance of transfer pricing processes
- Integration and standardization of of transfer pricing processes
- Improved data quality and automation allow for an increase in the frequency of transfer pricing monitoring and minimize the need and quantum of true-ups

There were several key concerns of the respondents:

- Accuracy and quality of data used for transfer pricing purposes
- Cross-functional teamwork and governance
- Using technology to enable improvements in processes
- Resource allocation and utilization

Nearly half of the respondents indicated that transfer prices are only monitored on an annual basis, with most process issues caused by the need for manual work and insufficient number of people

What is the Value to the Business

The role of a transfer pricing director generally encompasses the following activities:

- Developing transfer pricing / tax strategy and planning
- Developing transfer pricing policies and communicating policies to the business
- Preparing transfer pricing compliance documentation
- Gathering data and monitoring transfer pricing

In our experience, the most time of transfer pricing directors is spent on gathering data, monitoring transfer pricing and fulfilling annual compliance requirements

- These activities, while necessary, do not add significant value to the business
- The most value-activities often receive the least attention

Implementing an effective operational transfer pricing model can free up time to spend on the planning and strategy activities that generate value

Components of Operational Transfer Pricing

The first key component of an effective operational transfer pricing model is the budgeting and forecasting process

- It is during this process that the transfer pricing team works with the business, financial planning and related groups to evaluate legal entity and operational plans for the upcoming year
- The team gathers all the relevant data from the different sources to establish intercompany prices for the coming year and ensures that prices are consistent with intercompany agreements and existing policies
- Providing the ability to run various scenarios will allow the team to measure the impact of various inputs to the transfer pricing model

The second component is to build the intercompany pricing into the financial systems such that transactions are processed through the G/L

- Capturing intercompany transactions at the transactional level will help to support both the statutory and consolidated financial reporting
- Although directly linking to G/L systems is not a necessity, building analytical tools around feeds from the systems, and feeds that can go back into the systems, can significantly reduce the amount of time spent manipulating data

Components of Operational Transfer Pricing

The final component is the real-time TP monitoring

- By centralizing the data from the first two components, the transfer pricing team will be able to monitor the impact of transfer pricing in real time, rather than waiting for final close
- Real-time analysis allows the transfer pricing team to make prospective adjustments and see the results, rather than waiting until the last minute

Overlaying all of the components is the governance that is required to ensure proper controls

- Centralizing the operational transfer pricing and document management will ensure consistency of data, reports and agreements, and an audit trail for any calculations and adjustments made throughout the year
- Defining roles and responsibilities across a multi-functional team will help to provide visibility into the various transfer pricing processes

Moving Forward

To determine how to move forward with establishing/improving an operational transfer pricing model, companies have to assess a number of factors:

- Complexity of the intercompany transactions
- Number of parties to the intercompany transactions
- Quality of the existing data and processes
- Internal resources available
- Appetite for transformation
- Current challenges faced within existing transfer pricing models

In addition to the above factors, companies will likely also have to build a business case for undertaking the change, taking into account quantitative and qualitative benefits

- Quantitative benefits – ETR and cash tax benefits, efficiency and reduction in time spent on period-end close and compliance
- Qualitative benefits – risk avoidance, improve accuracy of reporting, timeliness of reporting and period-end close

There are two primary vehicles for building an operational transfer pricing model – third party technology and in-house (or in-house with advisors)

Moving Forward

Third party technology tools

- ThomsonReuters, SAP, and Oracle all offer technology to build out operational transfer pricing to varying degrees of automation
  - ThomsonReuters likely provides the most complete end-to-end software
- Benefits
  - Can handle large numbers of complex intercompany transactions
  - Can interface directly with in-house financial systems and automatically generate journal entries
  - Easily scalable as the business and number of intercompany transactions grows
  - Helps to reduce the reliance on emailing files, shared drives, etc.
- Challenges
  - Significant time and effort required from transfer pricing, tax, IT, financial planning and local entities for implementation
  - Generally a longer lead time to completion than an in-house solution
  - Learning curve required for all users of the technology

Moving Forward

In-house

- Companies can, either with advisors or on their own, develop in-house models to implement the operational transfer pricing model, primarily through MS Excel
- Benefits
  - Relatively simple to implement
  - Minimal learning curve on the part of users
  - Less costly
- Challenges
  - Can become unwieldy as the number and complexity of transactions increases
  - Less ability to control the inputs of users
  - Less ability to interface directly with internal financial systems

About Peters Advisors LLC

Peters Advisors LLC

Peters Advisors is an independent provider of transfer pricing and tax valuation services

- Founded in June 2009 by Dan Peters, former Global Transfer Pricing Services leader at KPMG
- Dan Peters and Sean Faulkner recently recognized for as a “Leading Transfer Pricing Advisor” by Euromoney’s Legal Media Group
- Awarded 2012 Transfer Pricing Firm of the Year – New York & New Jersey by Acquisition International
- We have consulted for a significant number of the world’s leading multinational corporations
- Currently 8 professionals; New Jersey-based
- Our team has experience working in transfer pricing at Big 4 accounting firms, independent valuation advisory firms, and in-house at Fortune 500 companies

Our Mission

- We have a passion for providing client service and delivering outstanding results through our commitment to bring you focused, insightful, and pragmatic advice
- We can bring an unmatched combination of expertise, experience and involvement to assist you with all aspects of the transfer pricing process

Our Value Proposition

- We provide a sensible rate structure and cost-efficient delivery of services
- Work is performed by senior-level, experienced professionals

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