Intercompany: The Case for Transformation

By Bill Marchionni, Jim O'Connor and Lynne Schneider

Executive Summary

Intercompany deserves attention because the risks of real cash flow and poor data integrity are substantial, ranging from inventory write-offs, top-side adjustments, wasted resources and financial integrity risk. Automation, standardization and reorganization of work to reduce the volume of intercompany transactions can save organizations from real headaches such as restatements and statutory reporting issues. But in addition, revisiting intercompany processes is likely to uncover significant value in the form of opportunities for lower costs and greater productivity. For example, organizations that tend to overlook intercompany accounting have traditionally compensated for their lack of process rigor with additional resources, a tactic that can become quite costly to sustain.

Due to recent global economic events, finance continues to be challenged to do more with fewer resources, and intercompany processing is no exception. In addition, this area is garnering increased scrutiny because of a post-crisis focus on controls and risk management. Although intercompany has not garnered a lot of attention for transformation historically, it has recently become an area of concern, with companies investing in systems to support financial consolidations and general ledger reporting activities and ultimately, improved transparency.

One of the best ways to assure data integrity is to examine intercompany processing. Although frequently ignored by finance leadership (given that it is an internal process), diagnosing the health of internal controls relies on understanding the different component processes related to recognizing revenue along the supply chain, which is essentially the crux of intercompany processing. Depending on a company's growth history, intercompany "clutter" takes many forms: intricately linked manual processes supported by one or two knowledge experts with many years of experience, processes that work smoothly until a payment or supply-chain issue arises, or mounting intercompany elimination account balances that carry over each month.

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Case study: Global life sciences manufacturer

Situation:

- Two years after being spun off from its parent company, a closer look by the company at its ongoing financial imbalance issues revealed intercompany non-eliminations as a material culprit.
- The company's complex effective tax structure conflicted with the flow of goods/services among legal entities, causing a number of process breakdowns extending from operations to finance.
- Accountability to resolve outstanding imbalance issues was not clearly defined between legal entities and corporate.

Approach taken:

- Baseline assessments were performed to understand how each intercompany transaction type was documented through disparate financial systems.
- Interviews with key intercompany stakeholders in operations, finance, IT, treasury and risk were conducted to identify root causes contributing to intercompany non-eliminations.

Results achieved:

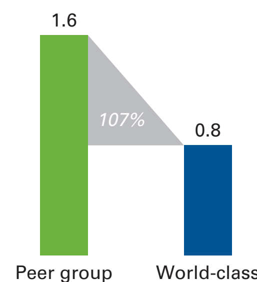
- New future-state intercompany processes to support disputes and settlements between trading partners were defined.
- Improved reporting through existing GL systems and new dispute/settlement management tools were implemented to enhance intercompany information transparency.
- Dedicated intercompany roles were established within finance to monitor and process ongoing intercompany disputes upfront to prevent non-elimination events from occurring during month-end close.

These trends can be viewed as an opportunity for the finance organization in general and intercompany accounting in particular to transform. The broad, diverse areas of traditional transformation also fit an endeavor centered specifically on intercompany issues, including:

- Improving the efficiency and effectiveness of intercompany processes.
- Maximizing automation and use of supporting financial systems to ensure data integrity and develop a reliable source of data for financial reporting and broader analytics.
- Advancing the capabilities of the function.

More importantly, intercompany has one of the largest disparities between the efficiency of world-class and peer-group finance organizations. Peers have twice as many FTEs per billion dollars of intercompany revenue **(Fig. 1)**. Organizations that tend to overlook intercompany accounting have traditionally compensated for a lack of process rigor with additional resources, a tactic that can become quite costly to sustain.

FIG. 1 FTEs per billion of intercompany revenue



Source: The Hackett Group, 2015

Instituting change involves the basics of accounting, ensuring that processes operate with the right controls, integrity, rigor and transparency, all while continuously achieving efficiencies. To get back on track, companies should focus on improving reconciliations and processing rigor, redistribute of work through leveraged models (such as Global Business Services/shared services) and seek greater visibility through new reporting methods and tools.

How Did We Get Here?

Companies do not aspire to have a large number of intercompany transactions and a complex record-keeping environment. The nature and volume of these transactions are generally created after business decisions have been made, without regard to their downstream impact on supporting intercompany processes and procedures.

Most intercompany issues arise (and multiply) during the month-end close, financial reporting and account reconciliation processes. Individually, various intercompany issues (e.g., resource time, duplicative processes, outstanding balances) may not be material and are often viewed as an insignificant source of potential value. However, from a total governance and control level, these disparate problems can easily strangle an organization, preventing it from completing financial and management reporting activities that require more attention during month-end close, and ultimately resulting in exposure risk.

Addressing complexity

Business complexity leads to additional complications when executing intercompany transactions. Structures and choices in policy can have significant effects on the number of intercompany transactions that must be executed and the difficulty of recording them properly and in a timely manner.

Addressing the following questions will have a marked effect on intercompany:

- Are any of the company's business units in highly regulated countries or industries? If so, how well do current processes handle invoicing, tax and other specialized requirements?
- What transfer pricing agreements exist and where does the documentation reside? Are they up to date? Can they be easily accessed for reference? How is compliance with these agreements (and the corresponding rates) enforced?
- Does the intercompany process span more than one ERP? If so, how does the company guarantee that the corresponding journals are all made in the same accounting period with the correct accounts to the correct units?
- Does the company have intercompany transactions in foreign currencies? If so, how does it handle booking foreign exchange journals, foreign exchange rate ladders, netting and settlement?
- How widespread is the need for intercompany transactions? For example, might employees who work in one company be booking travel expenses in another?

The effects of intercompany challenges don't end with a small group charged with reconciling these accounts. More resources isn't the answer; rather, there are broader financial implications **(Fig. 2)**. Therefore, it is paramount to tackle intercompany challenges head-on with the goal of making lasting changes that will prevent them from growing into a larger, systemic issue.

FIG. 2 Intercompany issues have broader financial implications

Intercompany issues	Broader financial implication
Ongoing intercompany imbalances remain unconfirmed after X days outstanding.	Potential risk exposure to write-offs increases without a formal dispute resolution process.
Resolving intercompany account reconciliation during month-end close involves "top-side" adjustments above the legal-entity level.	Material accuracy of tax liabilities and statutory reporting can cause conflicts with Sarbanes-Oxley audits and in-country reporting regulations.
Manual processes involved in tracking and reconciling monthly intercompany transactions are reliant on key finance-area experts.	Ownership and integrity of transactions are not contained within the general ledger, thereby distorting the "one source of truth" for financials.

Source: The Hackett Group

Over time, many companies have arrived at a disorganized intercompany process state because of gradual "creep" in the financial infrastructure and underlying complexity. Through changes in internal structure, mergers, acquisitions, or other business changes, the end result can be:

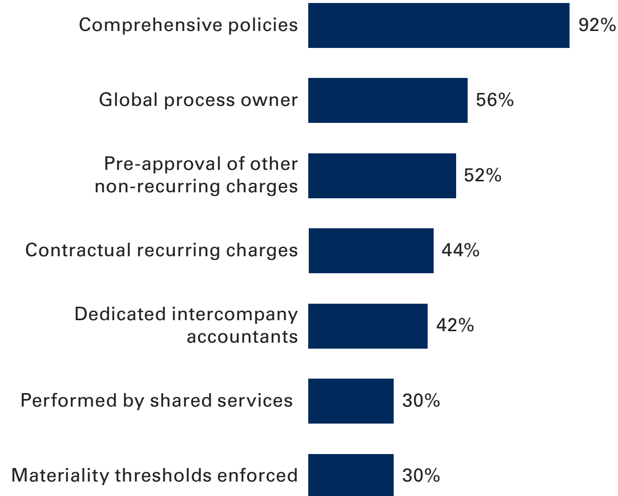
- Multiple ledgers and charts of accounts.
- Recent system implementations which do not yet rationalize the intercompany processes.
- Disparate ERP and/or operational systems that make cross-entity transactions more burdensome.
- Missing knowledge due to transfers or reductions in personnel.

Customer-facing processes are frequently ranked as the highest priority for continuous improvement, and rightly so. However, many companies fail to realize that internal processes (e.g., intercompany eliminations, dispute management) often dictate the relative strength or weakness of their own back-office controls. The true cost of current intercompany practices is revealed when the outlay required to maintain manual processes (or work around a lack of processes) drives revenue and cost amounts that are not fully realized along the intercompany sales chain. As the number of unresolved transactions builds, the probability of internal financial leakage rises. Clearly, the results can be severely damaging. This risk is often not fully appreciated or understood until the organization is actually faced with these issues.

The Transformation Opportunity

Our research indicates that about half of organizations have a high level of standards in place for the overall intercompany function. Broken down into specifics, the elements vary from a high of 92% with comprehensive policies to just 30% that enforce materiality thresholds and perform these tasks in a shared services environment **(Fig. 3)**.

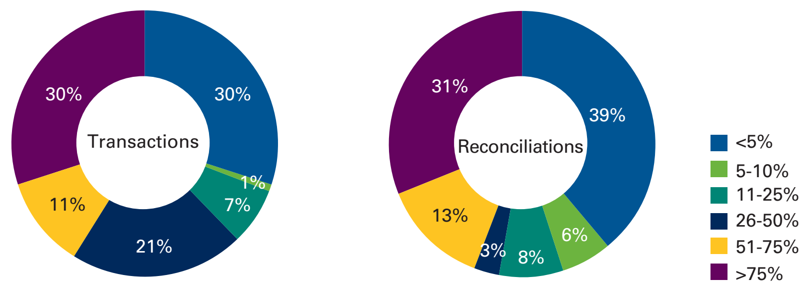
FIG. 3 Use of intercompany processes and standards



Source: Account-to-Report Process Performance Study, The Hackett Group, 2013

Automation is indispensable for reducing costs and errors. But, due to the complexity of the tasks, intercompany remains a highly manual process **(Fig. 4)**. Understanding the nature of intercompany transaction flows and setting effective process guidelines and standards to address defined intercompany scenarios will allow a greater percentage of processes to be automated.

FIG. 4 Percentage of intercompany processes automated



Source: Account-to-Report Process Performance Study, The Hackett Group, 2013

In order to accurately assess the state of intercompany processing, a clear understanding of supporting systems, processes and workforce capabilities is required. Investigating inputs/outputs and interdependencies with other financial and operational processes will reveal the root causes of problems, while evaluating existing technology that provides reconciliation support and monitoring controls will help determine whether the tools are successful process enablers. In most cases, diagnosing the health of intercompany processes will also shed light on parallel customer-facing issues such as billing accuracy, dispute management and collections effectiveness. In other words, addressing the root causes related to problems with intercompany processing can also improve customer relations.

When undertaking a transformation initiative, consider the following guidelines to help govern the process:

- **Look past surface symptoms.** Conduct an in-depth root cause analysis to identify the factors behind process discrepancies. Once these are identified, implement immediate measures to track progress over a specific time period to quantify the problem (e.g., number of reconciliations completed per month, number of intercompany confirmations performed on time).
- **Cleanup cannot be avoided.** Outstanding and ongoing intercompany imbalances need to be reconciled or written off depending on materiality in order to reset the baseline for intercompany process measurement. Adopting new processes is most effective when a cutoff point between old and new practices is established. When cleanup requires expense, such as in the case of having to make wire transfers, seek solutions that can reduce fees.
- **Establish "one source of truth."** Depending on legal entity setup and other organizational complexities, one common view of intercompany transactions needs to be used when communicating between trading partners. Whether intercompany detail is distributed via spreadsheet reporting or via shared "read-only" views in a system, define the single source of data and make its use mandatory.

The transformation can be fast-paced and comprehensive or handled incrementally. In **Fig. 5** below, we present some smaller projects that can be used to jump-start the process. While modest in scope, these actions can help prove the case that investments in intercompany improvements return high value.

FIG. 5 Examples of people, process and technology-related intercompany initiatives

Process	Technology	People
Institute a monthly confirmation process for all tradition partners, with clear deadlines and definitions for what constitutes a "confirmed balance."	Create an "intercompany balance portal" in a shared tool that allows transaction partners to view their due-to and due-from for offline analysis (e.g., ERP, business analytics tool)	Create an intercompany hub/ Center of Excellence to expedite the resolution of disputes and escalations.
Run regular intercompany DSO reports to monitor timely resolution of intercompany disputes and watch for financial leakage.	Minimize the number of GL systems and variations in the chart of accounts for intercompany accounts where possible.	Assign accountability for maintaining "clean" intercompany balances to one group (e.g., FP&A, internal controls).
Incorporate the setup of transfer prices between trading partners as a part of new legal entity set-up processes.	Use technology incrementally and migrate to a more systematic solution.	Define and communicate how roles and responsibilities are structured around key elements such as dispute resolution, escalation management and intercompany reconciliation.
Create material cascading measures that facilitate faster signoff on finalized account reconciliations.	Resolve any historical imbalance issues that may have resulted from system conversions.	

Source: The Hackett Group

Case study: Industrial products provider

Situation:

- Reconciliation issues impacting month-end close and reporting resulting from ERP adoption.
- Visibility raised to internal audit committee, three to six-month timeline to address unexplained balances.

Approach taken:

- Project focused on improving stability of the company's ERP system and reporting tool.
- Analyzed and redesigned controls, accounting reconciliation procedures, intercompany policies and inventory movement practices.
- Used detailed T-account analysis and auto-match approaches to uncover and resolve issues.

Results realized:

- New and improved procedures, processes and tools constructed.
- Reimplemented reporting tool and made configuration changes to the ERP system.
- Reduced financial exposure and saved approximately $10 million in potential write-offs.

Strategic Implications

Intercompany may feel like "Monopoly money" to some, but it deserves attention because the risks of real cash flow and poor data integrity are substantial, ranging from inventory write-offs, top-side adjustments, wasted resources and financial integrity risk to major financial exposure.

Establishing performance measures (and/or interim assessments) of the intercompany process is the first step in understanding the situation and determining whether action is needed. If so, process remediation often involves two concurrent but separate tracks: first, establishing visibility to the current state and addressing historical issues, and second, designing a sounder and better-integrated future-state process to minimize risk and sustain financial integrity.

The classic symptoms of intercompany issues – top-level intercompany imbalances, poorly understood transfer pricing, and significant volumes of processing and personnel time – can be clues that action is needed. Intercompany assessments are like a cholesterol check for finance processes. If the organization's cholesterol exceeds the healthy range, immediate action is needed to prevent more significant problems in the future (e.g., restatements or statutory reporting issues). Intercompany requires careful performance monitoring and on occasion, surgery, to restore the processes to health.

Related Hackett Research

"The Close-Related Practices of Top Performers: Essential Steps for a Better Monthly Close," August 2015

"Leaders of Account-to-Report: Key Performance Levels and Methods," April 2014

"The Account-to-Report Service Delivery Model, Part 1: Optimizing Service Placement to Maximize Accounting Leverage," August 2013

About the Advisors

William Marchionni
Practice Leader, Finance Operations Advisory Program

Mr. Marchionni provides CFOs and other finance leaders with insight and analysis gained during over 20 years of work in consulting and in the private sector. He has particular expertise in the areas of revenue and cost management; working capital management; process reengineering; and strategic planning, forecasting and analysis. Prior to joining The Hackett Group, Mr. Marchionni, a certified public accountant, served as CFO of a privately held diversified consumer products company. Previously, he was vice president of finance for Atlanta Gas Light Company, a wholly owned subsidiary of AGL Resources, a $1 billion publicly traded diversified energy company. In this role, he was responsible for the financial operations of an $800 million business unit, including capital investments, revenue management, cost reduction initiatives, strategic planning and financial analysis.

Jim O'Connor

Global Practice Leader, Global Business Services and Finance Advisory Programs

Mr. O'Connor has over 20 years of both industry and consulting experience focusing on finance transformation. He has particular expertise in strategy and organization design, business process design, strategic cost reduction, reporting, planning and performance management, BI and financial systems, shared services and outsourcing. In these roles, he has advised client executives in a wide range of industries including consumer products, financial services, higher education, manufacturing, retail, and utilities. Previously, he led the CFO Services practice at North Highland, a global consulting firm, and before that, focused on finance transformation and strategy at Archstone Consulting, now a part of The Hackett Group.

Lynne Schneider

Senior Research Director

Ms. Schneider is responsible for leading the development of research and other intellectual property for The Hackett Group's Executive Advisory Programs in Finance and Enterprise Performance Management. She has worked in consulting and related research for over 20 years. Her previous positions included Director of Research for Kennedy Consulting Research and Advisory, as well as a variety of internal and external consulting positions with international companies. As Director of Business Process Improvement at American Greetings, Ms. Schneider managed a portfolio of strategic and operations projects, including both staff and line functions. She was also a senior consultant in Towers Watson's Organization Effectiveness practice and a consultant in the Change Management practice at Accenture.

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Email: info@thehackettgroup.com

www.thehackettgroup.com

Atlanta +1 770 225 3600 London +44 20 7398 9100 Sydney +61 2 9299 8830

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