Developing a transfer pricing control framework

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<table>
<thead>
<tr>
<th>#</th>
<th>Particulars</th>
<th>Slide</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Global transfer pricing environment</td>
<td>2</td>
</tr>
<tr>
<td>2.</td>
<td>Consequences for companies</td>
<td>3</td>
</tr>
<tr>
<td>3.</td>
<td>Transfer Pricing Control Framework</td>
<td>4</td>
</tr>
<tr>
<td>4.</td>
<td>Set-up of a Transfer Pricing Control Framework</td>
<td>5</td>
</tr>
<tr>
<td>5.</td>
<td>Benefits of a Transfer Pricing Control Framework</td>
<td>11</td>
</tr>
<tr>
<td>6.</td>
<td>How can we help?</td>
<td>12</td>
</tr>
<tr>
<td>7.</td>
<td>Credentials</td>
<td>13</td>
</tr>
</tbody>
</table>
Global transfer pricing environment

Developments that require action

**Media pressure**
Transfer pricing is a front-page issue (IKEA, Google, Amazon, Starbucks, etc.)

**Cross-border information sharing**
Increase of information flow between the revenue authorities, both documentation and rulings

**BEPS actions**
For transfer pricing documentation (BEPS 13) and intangibles (BEPS 8-10) recommendations are significant

**Public scrutiny**
Social media and ongoing global internet commentary

**Political agendas**
Government inquiries heightening focus on corporates’ tax practices, including transfer pricing

**Changes in domestic legislation**
Countries jumping ahead of BEPS agenda

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A storm for global controversy in transfer pricing

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Developing a transfer pricing control framework 2
Consequences for companies

Focal points

Aggressive attitude of tax authorities

In the post-BEPS world, tax authorities are becoming increasingly interested in the international tax and transfer pricing policies applied by an MNE. Local tax authorities obtain much of their auditing information from transfer pricing documentations and CBCR. Tax authorities also increasingly expect tax and transfer pricing to be on the boardroom agenda and look to take a real time approach to compliance.

Internal roles and responsibilities

Tax departments are increasingly required to cooperate closely with other functions within the company, such as the financial, legal, risk management and IT functions. The accountability for transfer pricing is more and more elevated from the tax function to the CFO or board level.

Tax risk management system

Tax authorities are highly interested in the existence and quality of tax risk management system of an MNE and try to build on this based on the actual tax audit on what is already controlled and documented by the MNE. Having said that, the MNEs that lack tax and transfer pricing controls are likely to be flagged as high risk and will face increased scrutiny.

Governance and stakeholder management

Tax and transfer pricing risk management as a part of good governance should be on the agenda of the board/finance and tax function of the MNE. With multiple stakeholders taking an interest in tax, MNEs are increasingly focused on understanding the effectiveness of their transfer pricing control framework and how this can be articulated to all stakeholders.
In essence, the tax control framework should be embedded in overall business controls. Such business controls are often based on the “COSO” model which is an Enterprise Risk Management model used by MNEs to reduce and manage financial and other risks as well as to become in control.

By application of the aforesaid model, specifically to the fiscal function of the MNE, a so-called Tax Control Framework ("TCF") is established. The TCF is a framework which allows the MNE to control the overall fiscal function by identifying the tax risks and developing internal control measures to mitigate the identified risks.

As an integral part of the TCF, the Transfer Pricing Control Framework offers a structured approach for robust implementation and monitoring of the MNE’s transfer prices.

In the next slides, a number of steps are presented that would need to be undertaken for setting up a Transfer Pricing Control Framework.
Set-up of a Transfer Pricing Control Framework

**Step plan**

### Step 1: Risk assessment

**Activities**
- Gain understanding of existing situation
- Stakeholder management / buy-in
- Risks identification along lines of:
  - People;
  - Processes;
  - IT.
- Risk prioritization

**Output**
- Workshop memos
- List with prioritized risks

### Step 2: Develop processes and controls

**Activities**
- Selection of risks
- Development of processes and controls
- Co-operation with relevant stakeholders

**Output**
- Defined TP controls
- Process descriptions and KPIs
- Flow charts
- Risk & control matrix

### Step 3: Information and training

**Activities**
- Actual implementation:
  - People;
  - Processes;
  - IT.
- Communication with relevant stakeholders
- Training sessions

**Output**
- Manuals
- Implementation meetings
- Communication protocol

### Step 4: Monitoring controls and processes

**Activities**
- Continuous monitoring
- Stakeholder management
- Continuous improvement

**Output**
- (Internal) audit report
- Board presentation
- Deficiency report

"Feedback and continuous improvement"
Step 1: Risk assessment – our approach

- Based on a sound understanding of a company’s strategic direction, tax agenda, business operations, existing risk control framework and other characteristics of the company (also “tone at the top” and competences of employees), the transfer pricing risks can be identified. These risks are different in each company, but can be identified around three main dimensions:
  - People, e.g. local finance staff is not paying attention to transfer pricing “red flags” because they are not aware of the issue (e.g. intercompany transactions with a negative gross margin)
  - Processes, e.g. end of year transfer pricing adjustments are calculated by the tax department, but there is no process that triggers the issue of the relevant debit/credit note
  - IT systems, e.g. financial information may not be reliable for transfer pricing purposes due to various legacy IT systems

- Often a risks assessment exercise is conducted through a workshop with different functions involved, such as the tax department, finance department (central and local), local managing directors and internal audit. Apart from the fact that transfer pricing risks may arise in various areas, a mutual workshop often enhances the buy-in for any further steps

- Summarizing the various transfer pricing risks provides the opportunity to prioritize the risks based on certain considerations. Very often the probability the risk may occur (likelihood) and the size of the possible transfer pricing correction are used as indicators. But also potential impact on a company’s reputation may play a role
Set-up of a Transfer Pricing Control Framework

Step 2: Develop processes and controls – our approach

• Based on the prioritized list of transfer pricing risks, a selection could be made of the risks the company would actively seek to reduce. For these risks countermeasures need to be developed. However, any existing procedures and controls or risk control frameworks will-to the extent possible- be utilized as a starting point for the newly developed transfer pricing specific procedures and controls

• A robust set of transfer pricing procedures and controls contains a number of constituting elements:
  • Narrative of the entire (end to end) transfer pricing process and each of the sub-processes
  • Flow-charts of the various sub-processes (“process maps”)
  • Risk and control matrix for each of the sub-processes identified

• Actual implementation of the transfer pricing processes and controls needs to be undertaken in close co-operation with the relevant stakeholders to ensure that specific knowledge about certain processes and controls is obtained and the actual execution -once implemented- will be conducted appropriately
Set-up of a Transfer Pricing Control Framework

Step 3: Information and training – our approach

• As part of the implementation of the new transfer pricing related procedures and controls, it will be absolutely crucial that all relevant stakeholders in the company receive the appropriate information.

• Sufficient information should be provided to the tax and finance staff, both at head-office and local level. In addition, it may be wise to also involve other stakeholders such as the internal audit department or the (supervisory) board. All stakeholders need to know what, why, how, and when, for example:
  • It should be made clear how roles and responsibilities are organized with respect to transfer pricing in order to know who is responsible for a certain aspect, or to channel or escalate information in case of any developing issues.
  • If staff members do not have the relevant knowledge, it could be considered to develop training programs for them or to set up a help desk function.
  • In a process description it could be prescribed at what particular moments (e.g. within the ordinary financial reporting cycle) certain transfer pricing specific activities need to be undertaken.
Set-up of a Transfer Pricing Control Framework

Step 4: Monitoring processes and controls – our approach

- Risk measures and processes need to be monitored continuously to analyze whether they are implemented in the daily operations of the company and whether they actually accomplish their goals.

- Monitoring activities should be formulated, as well as evaluations with respect to the set-up of the transfer pricing policy and its implementation, including scope and frequency of the activities. Dependent on the stakeholders (e.g. internal/external audit, finance, tax, board) the intensity of the monitoring activities should be determined. Depending on the risk measure or process, analytical or detailed tests may be performed. These tests may be conducted internally (i.e. internal audit department) or with the help of an external advisor.

- It should be defined when, how and to whom internal control deficiencies should be reported. A deliverable of the monitoring activities could be a periodic charter indicating the performed activities and evaluations, frequency, responsible persons and findings.
Set-up of a Transfer Pricing Control Framework

Key takeaways

1. To create maximum efficiency and effectiveness, the controls should be embedded in an existing process as much as possible (for example the monthly financial closing cycle). The more embedded the controls are, the higher the likelihood that they are accepted by the relevant responsible staff members and appropriately executed.

2. In order to demonstrate the operating effectiveness of the controls, it is necessary to document evidence of the control being executed. This creates an audit trail needed in case a request is made to demonstrate the operating effectiveness of the controls, or in case disclosure is required of certain conclusions reached and considerations made in the process.

3. Setting-up a transfer pricing structure and documenting the arm’s length nature is one of the responsibilities of the tax department. Designing, implementing, testing and maintaining controls or a control framework for transfer pricing is an activity that goes beyond the boundaries of the tax department. Experience learns that successful execution of a transfer pricing structure can only be ensured when various departments communicate and operate together in this area.

4. To obtain acceptance for processes and controls in the wider business operations, sufficient support from senior management and executive level is needed. If this is left at a too low level of seniority in the organization, there is a reasonable chance that there will be insufficient acceptance by other departments than tax. The appropriate tone at the top is therefore crucial for the success of a project in this field.

5. Maintaining and continuously improving your controls and control framework requires periodic verification by (internal or external) audit, followed by remedial actions for the exceptions identified. Having the operating effectiveness of your controls audited has a preventive as well as a detective angle.
Benefits of a Transfer Pricing Control Framework

Advantages

1. Going through the various steps of the Transfer Pricing Control Framework provides a fundamental approach to identify possible transfer pricing risks and to establish measures and processes, which would lead to a mitigation of these risks.

2. In communications with tax authorities, for example, in tax audits or in enhanced relationship situations, the Transfer Pricing Control Framework could be a helpful communication tool to explain that the company is in control.

3. A number of practical issues could be made more transparent through the Transfer Pricing Control Framework, such as the bridging between the various sets of annual accounts (i.e. management, group, statutory and tax reporting) and the quantification of the (uncertain) tax position in the statutory accounts.

4. A Transfer Pricing Control Framework may enhance the retention of knowledge in case key staff members would leave the company or need to rotate within the company.

Going through the various steps of the Transfer Pricing Control Framework provides a fundamental approach to identify possible transfer pricing risks and to establish measures and processes, which would lead to a mitigation of these risks.
How can we help?

Our services

- Organizing a workshop to take stock of the perceived level of control over transfer pricing and to determine the way forward
- Being a sparring partner in case your company would like to set up a Transfer Pricing Control Framework in-house
- Providing advise to set up a new or enhance an existing Transfer Pricing Control Framework
- Preparation of various documents, such as manuals, process descriptions, flow charts, risk & control matrix, communication memo, etc.
- Preparation of an operating effectiveness report, e.g. in the form of an Agreed Upon Procedures report
- Providing training sessions to internal audit departments focused on transfer pricing procedures and controls
A multinational group requested us for assistance in the establishment of a Transfer Pricing Control Framework. We suggested commencing with a workshop, whereby we used a diagnostic tool as a means to take stock in terms of, for example, existing risk and control frameworks, support from senior management, perceived transfer pricing risk areas and awareness of key staff members for the issue.

Prior to the workshop, we asked various key staff members from a number of departments, i.e. tax, finance, risk management and internal audit to fill out the diagnostic tool. The findings were analyzed and served as input for discussions during a one day workshop where all respondents were participating.

The deliverable of the workshop was a memorandum with a common opinion of the key staff members’ perceived current status of control over transfer pricing, and the desired level of control. The workshop also allowed the tax department to set priorities in terms of what transfer pricing risks would require most immediate attention. In addition, the workshop created a significant level of buy-in from the relevant stakeholders.”
“For a Dutch based, quoted company we performed a review to analyze whether the actual conduct of the staff in the field was in alignment with the transfer pricing documentation.

Based on interviews held with the local (finance and sales) staff, we concluded that a number of gaps existed between the documentation and the day-to-day operations. The gaps were reported to the tax department in an advisory letter which also contained suggested improvements.

The client endorsed a number of the improvements and decided to establish a task force to implement a number of additional processes and controls. Based on the report the client mitigated its transfer pricing (and related risks like withholding tax and permanent establishment risks) significantly, also leading to a decrease of the tax provision in its annual accounts.”
"For a multinational company with a centralized supply chain structure in Switzerland, we conducted an Agreed Upon Procedures engagement. Main goal was to establish a defense line that would substantiate transfer of part of group subsidiaries’ profits to Switzerland vis-à-vis the tax authorities in the respective countries of those subsidiaries. Based on our experience with potential requests from tax authorities on centralized supply chain structures we defined, together with the client, a number of transfer pricing procedures that would likely be tested in case of a tax audit.

Subsequently we examined whether the procedures were conducted accurately in practice. The deliverable of this review process was an Agreed Upon Procedures report that could be handed over to the tax authorities in the various countries, if requested. The report not only provided the client with a first line of defense towards the tax authorities, but also allowed the client to make certain adjustments based on deficiencies we noted in our report"