Becoming a Multinational Finance Department

A Checklist of Financial Management System Requirements

White Paper

Sponsored by

INFOR™

VENTANA RESEARCH

Aligning Business and IT To Improve Performance

Ventana Research
6150 Stoneridge Mall Road, Suite 350
Pleasanton, CA 94588
info@ventanaresearch.com
(925) 474-0060
www.ventanaresearch.com

Table of Contents

The Challenge of Change

Finance departments in companies that expand by entering new country markets find there are an array of new requirements they must master. Operating in multiple national jurisdictions requires, at the very least, working with different currency, language, laws and regulations. It's essential for the CFO, controller and head of accounting to understand the full array of systems requirements that the finance department of a multinational company needs to address to operate efficiently and effectively. Once the team is clear on what will be required, they will have to determine whether the current core financial system can handle the demands of a true multinational organization. If it isn't, Ventana Research recommends replacing it as quickly as possible.

Changing a financial management system is not something executives take lightly, nor should they. Replacing existing systems is often an expensive and time-consuming undertaking. However, all business executives should understand that choosing to continue as is can lead to a costly dead end. As a company transitions from a purely domestic player to a multinational one, there is a natural tendency to try to minimize costs and disruptions by continuing to use existing systems. But without the right software, the finance organization will likely find itself spending a lot of extra time coping with the shortcomings of the existing application. This is time that would be better spent, for example, providing timely, accurate financial reports and analysis. Ventana Research recommends adopting a financial management system designed for multinational companies because it will enable the finance department to handle the changes and keep the organization growing.

Changing a financial management system is not something executives take lightly – nor should they.

Constructing the Checklist

Determining whether a company needs to change or augment its financial management systems to effectively manage international growth should start with a rigorous evaluation of standards that any successful multinational company must be able to meet. Two consistent themes should run through this evaluation: identifying complexity and developing the flexibility to respond to it. Operating in multiple countries means obeying multiple laws, regulations, rules and customs requirements simultaneously. A multinational's financial management system must be able to address all of these requirements wherever and however it operates. Ventana Research finds that when a company lacks the flexibility to deal with complexity, its finance department winds up spending unproductive hours continuously adjusting and recalculating numbers and reports to meet each set of local requirements, as well as checking for and correcting errors. Each item on an organization's evaluation checklist should answer a fundamental question in as much detail as necessary.

Currency Complexity

How well does the financial management system handle multiple currencies? In today's global economy, a financial management system must be able to accurately and efficiently handle the complexities of operating in multi-currency environments. Although the basic concept of currency translation is simple, in practice translations are problematical because accounting and business rules require different categories of exchange rates depending on circumstances. This may have mattered less in past decades, but exchange rates have also grown far more volatile; day-to-day swings of a full percentage point or more have become common.

Even if a corporation has to deal with only one set of accounting rules today, Ventana Research recommends ensuring that it has the ability to handle additional ones as well in the future.

Generally accepted accounting principles (GAAP) govern which method applies to the items for the balance sheet, the income statement and the statement of cash flows. It's complicated enough if a company has to worry about only one set of accounting rules, but requirements may be different if it has to report its figures in multiple countries under different GAAP regimes, such as U.S. GAAP vs. International Financial Reporting Standards (IFRS). For example, a not-for-profit organization may be headquartered in the United States but operate a program in Kenya funded by a Danish charitable institution. It will need to track its expenditures in Kenyan Shillings, then translate these into both Krone (for fund accounting purposes) and U.S. dollars (for the consolidated accounts). Or a company may find itself having to alter exchange rate calculations to deal with tax laws that deviate from local GAAPs or to comply with contracts such as joint venture agreements that mandate a different method.

Even if a corporation has to deal with only one set of rules today, Ventana Research recommends ensuring it has the ability to handle additional ones as well in the future.

Speaking the Language

Can the organization's financial management system be localized? This white paper is written in English, which has become the default language of business worldwide – for now. Yet while it's reasonable to assume the executives in a multinational company can read and speak English, day-to-day operations are likely to be handled by people who have little or no grasp of the terminology and statutory reports (including those related to business registration, economic census and tax filings) that have to be submitted in each country's language. Beyond the language, different units of weights and measures likely will have to be used to describe products or packaging. It's important to recognize that even something as basic as paper sizes for forms or invoices may differ from country to country.

It's therefore imperative that a company's financial management software have the ability to handle the multiple languages, measures and formats that are required today and potentially will be in the future. Ventana Research strongly advises companies to ensure they have a financial management system that can easily and simultaneously handle multiple languages, units of measure and even formats. Only in this way can an organization be certain it will easily be able to operate in a multinational environment.

Here an Entity, There an Entity

Does the existing financial management system allow for multiple discrete entities? To those on the outside, the company is a single organization. Legally, though, it is an assemblage of entities, each with a specific legal structure operating in a set of legal jurisdictions. The ability of a financial management system to keep track of individual legal entities is important for statutory reporting and tax purposes. The results of entities may need to be consolidated in one way for some purposes (say, a regulatory report or a VAT return) but in another way for another purpose (for example, management reporting).

So, for instance, a diversified financial services company in Europe that owns a bank with headquarters in Country A and a small lending institution in Country B not only will have to be able to provide B with the subsidiary's figures but also will have to recast the parent company's data to fit B's reporting requirements. And, of course, it must monitor all relevant metrics to ensure ongoing compliance with all the applicable capital adequacy rules.

Maintaining multiple charts of accounts may prove to be both simpler in the long run and more productive.

Supporting Different Charts of Accounts

Can the existing financial management software support multiple charts of accounts? A company's "books" can be multiple sets of books, and each of these can have its own chart of accounts. One school of thought holds that it is best for a company to have a single, universal chart of accounts because it can simplify[dl1] the consolidation of company-wide data for internal and external reporting.

While this may be the best approach for some companies, for others it may not be feasible or even advisable, especially if the company encompasses fundamentally different lines of businesses, is working in a joint venture arrangement or acquires a business in another country. Some countries even have statutorily defined charts of accounts. Sticking to a single chart of accounts structure is inherently a rigid approach. Maintaining multiple charts of accounts may prove to be both simpler in the long run and more productive, especially since today's financial management systems can easily handle multiple charts of accounts.

What Year Is It?

Are there limits to the number and types of calendars supported by the existing system? If every company everywhere operated on the same fiscal year, there would be no need to accommodate multiple calendar structures in a financial management system. However, that's not the case. Two-thirds of public companies in the United States and a majority of those in the U.K., France and Germany have fiscal years that end in December. Many Japanese companies end their years in March to be consistent with their government's calendar, while in Italy the fiscal year typically ends in June. Sweden permits December, April, June and August fiscal years, and corporations can receive permission to use another month as their year-end.

To further complicate matters, some companies (especially in manufacturing and retail) use a quarterly "4-4-5" calendar in which the first two "months" have four weeks and the final "month" has five, all ending on the same day of the week.

Companies that have multinational operations may find it is better (or necessary) to adopt different calendars in different locations. Because of this, Ventana Research asserts that it's best to have a financial management system that can create local, regional and consolidated reports as needed for management or statutory purposes. Otherwise, a company will find itself wasting valuable staff time recasting its numbers into different calendars.

Taxes: When a Cake Is Really a Cookie

<u>How well will the existing software support the tax department in a multinational environment?</u> Taxes, both direct (that is, income-related) and indirect (that is, sales-, use- or value-added) introduce another layer (even layers) of complexity because with few exceptions, tax codes are festooned with a multiplicity of rates, rules and exemptions that only increase over time. Accounting and tax concepts are not always aligned, and treatments differ from one jurisdiction to the next.

Indirect taxes are notoriously quirky. For example, the company that makes the cookie-shaped Jaffa Cake successfully defended its assertion that for VAT purposes its product is a small cake and not, as the taxing authorities asserted, a cookie (actually a "biscuit," since this case was brought in the U.K.) and so qualified for a lower tax rate.

Having a financial management system that can be tax-aware for every location makes mistakes less likely and defending a tax audit easier.

For a multinational's financial management system to handle the complexities associated with differing tax regimes, it must address multiple entities, charts of accounts, depreciation schedules and calendars that may vary for each local tax jurisdiction. This typically requires making an up-front investment in configuring the system to be "tax-aware" in order to substantially reduce the amount of time the tax department otherwise would have to spend doing back-end calculations in spreadsheets. Having a financial management system that can be tax-aware for every location makes mistakes less likely and defending a tax audit easier.

Taxes: Defending Transfer Pricing

How well could your tax department or tax counsel mount a transfer pricing defense? Transfer pricing is a fixture of operating multinationally. Companies routinely create products or services in their legal entity in country A and then sell them through their entity in country B. What price should the entity in A charge the one in B? If tax rates in A and B are significantly different, the decision can have a material impact on taxes paid and on the bottom line. From a legal standpoint, the right transfer price is often a matter of interpretation. If it is deftly handled by adopting the most aggressive transfer pricing allowable under applicable laws, a company can save a considerable amount of money. Not surprisingly, transfer pricing is also an area that tax authorities scrutinize closely.

Managing transfer pricing effectively means being able to prevail in defending the company's position. Although a number of factors go into a successful defense, being able to quickly produce the underlying calculations and demonstrate that the pricing process has been applied consistently are key components. Companies that are unable to automate and control the transfer pricing process will wind up spending more time and effort reproducing their calculations and defending their transfer pricing decisions; they also are more prone to have made avoidable errors in the first place. Ventana Research recommends asking the organization's tax professionals how easy it would be for them to mount a tax audit defense using the existing financial management application. If they report that it cannot do the job well, consider whether the cost of internal resources, professional fees and (potentially) the fines and penalties associated with an unsuccessful transfer pricing defense are worth it.

Reporting Results Using Multiple GAAPs

Does the organization's current software support reporting using multiple sets of generally accepted accounting principles? It's true that in recent decades there has been an international convergence of GAAPs; nonetheless, multiple GAAPs remain. And even countries that have adopted IFRS differ in how they apply that standard. Moreover, it's likely that the version of IFRS the United States ultimately adopts will be substantially different from the European version (for instance, in revenue recognition).

A multinational company's financial management system must be able to facilitate the production and auditing of all the different levels of corporate report that are needed.

Companies operating in countries with different GAAPs almost certainly will need to produce financial statements in these countries for both their local subsidiaries and the home country. All of this translates into the need to be able to simultaneously close the books and create financial statements and reports using multiple sets of GAAP rules. Being able to do so automatically means the process will proceed more quickly, accurately and with much less effort than if it were done manually.

Be Global, Report Local

Can your financial management system automate the production of financial statements in each jurisdiction that requires one, using the required GAAP in each instance? This may be a contractual requirement (if, for example, a company is engaged in a joint venture or a franchised business) or it may be required by local or national governments. At the same time, it's also important to be able to create a consolidated headquarters view and perhaps as well a consolidated statement of several subsidiaries at an intermediate level. A multinational company's financial management system must be able to facilitate the production and auditing of all the different levels of corporate reports that are needed.

Gaining Accessibility Worldwide

Does the financial management software allow Web-based access? Multinational companies need the option of accessing their system either through a direct connection on-premises or via the Internet. Web access is essential for organizations that have operations in places where they cannot or choose not to pay to support an on-premises financial management system. This may be a country or city where trained IT staff isn't available or the cost is prohibitive. Or the organization may have a country headquarters but also numerous small retail outlets or distribution sites across the country that need access to the financial systems but where individual installations do not make sense. Rather than using an additional system, such organizations should deploy one financial management system that allows both on-premises deployments and Internet access while providing ironclad security and reliability.

Taking On the Challenge

If going through these checklist items leads to the conclusion that existing financial management systems cannot support the new set of needs, the organization should evaluate the fiscal and other impacts on the finance department of taking steps to maintain the existing system. At the same time, though, it's appropriate to also do a cost/benefit analysis of acquiring a replacement. That analysis should cover the current system's ability to:

- address both today's and tomorrow's challenges.
- manage complexity by reducing manual input wherever possible.
- report results quickly and accurately in the required formats.
- comply with local laws, regulations and accounting codes.

Start Now – It's Important

Like electricity or telephone service, a financial management system is essential for a smoothly functioning business. Because of the cost and disruption of changing a core financial management system, companies are naturally reluctant to replace theirs until it is absolutely necessary. Most companies outgrow their old systems gradually, and the increasing inefficiency of working around the software's limitations can go unnoticed. When a corporation begins to operate as a multinational, however, the increase in requirements happens quickly, and the finance department can be overwhelmed by the more complex environment in which it is now operating.

Multinational companies need a financial system that enables them to deal with this complexity efficiently and provides them with the flexibility to meet the broader range of requirements that are part of doing business across national borders. Moreover, the system must enable them to adapt quickly as local laws and regulations change and as the company expands into new countries or regions.

When a corporation begins to operate as a multinational, the increase in requirements happens quickly, and the finance department can be overwhelmed.

Senior executives and their board of directors must recognize that having the right financial management system is one of the main requirements to operate effectively in multiple countries. They must assess whether the existing system will meet these requirements and, if it won't, move quickly to get the right system in place as soon as possible.

Ventana Research recommends organizations avoid the tempting inclination to put off upgrading the financial management because "now is not the right time" or because someone wants to wait to have a first-hand understanding of what the company will need. Anyone who has worked in a finance organization that took this approach knows it is a mistake. Delay results in a scramble to complete the accounting cycle on time, meet statutory filing requirements within deadlines, and do this while ensuring the books are error-free. Finance professionals know that audits in this sort of environment are much more difficult because it's harder to examine the scattered array of spreadsheets and their often-complex formulas. And they know that it's much more difficult to implement a new system when the department is already stretched thin by the extra work required when a company goes multinational without a multinational financial management system in place.

About Ventana Research

Ventana Research is the leading benchmark research and advisory services firm. We provide expert guidance to help organizations manage and optimize performance – to become not only more efficient but more effective. Our unparalleled insights and best practices guidance are based on our rigorous, research-based benchmarking of people, processes, information and technology across business and IT functions worldwide. The combination we offer of benchmark research, thorough market coverage and in-depth knowledge of hundreds of technology providers means we can deliver business and technology education and expertise to our clients where and when you need them. Ventana Research provides the most comprehensive analyst coverage in the industry; more than 2.5 million business and IT professionals around the world benefit from Ventana Research's insights. To learn how our benchmark research and assessment and advisory services can improve your organization's performance, visit www.ventanaresearch.com.