The Reconciliation of Intra-Group Transactions

How to improve process productivity and reliability

A Prophix Whitepaper

Introduction

> The obligation to reconcile intercos is covered briefly in the IFRS standards, but practical aspects are not. It is therefore up to groups to implement the best possible process to eliminate intercos from the balance sheet and income statement, a preliminary step to consolidation.

It would appear today that, in many groups, interco reconciliation is still:

- A “consolidation” team responsibility, although these teams only have a very limited view of the overall situation. The goal is to reconcile transactions which took place at the local entity level and in their corporate accounting
- A resource-intensive process: one or more people have to be fully dedicated for a period of time to collecting the data to be reconciled and to resolving disputes
- A time-consuming process, which it is tempting to rush through when the deadline for closing the books is approaching quickly. The tactics used include forced entries, alignment on the seller, etc. to go faster and meet closing deadlines
- A difficult process to audit

Can a simpler and more effective process be implemented?

This table summarises the process we recommend and compares it to a traditional process with its limitations. The optimal process is detailed in the following pages.

	Traditional process	Optimal process
At what level does interco reconciliation take place?	In the consolidation department	In local accounting departments
When?	During the consolidation period	During local accounting close
Tool used	Excel Or consolidation software functionality (automatic centralised reconciliation of counterparty positions – differences are resolved outside of the tool) Or a balance reconciliation tool (the reconciliation process is part of the consolidation - balance reconciliation process)	Transaction reconciliation software/ transaction matching for automatic reconciliation/the reconciliation process is done at the local accounting department level and can be corrected, if required, to ensure better financial data quality, or, that the tool is a collaborative platform for more effective communication between the different people involved
In the event of differences	Exchange of Excel files, alignment on the seller, etc The consolidation department is copied on all email exchanges between the entities and is quickly overwhelmed Difficult to justify differences, lack of time	The goal of the reconciliation isn't to get a zero difference, but to be able to justify differences Differences are explained and information is provided to the consolidation department for required journal entries Local accounting is corrected with the right information, if necessary
Results	Risk of consolidation process delays which can result in forced entries The fast close is endangered (number quality versus meeting the close deadline) Lack of reliability Consolidation department time wasted, resources are used for low added-value work	Automatic matching of alltransactions Only non-reconciled transactions are studied Reconciliation is done before the close process and doesn't interfere with it Consolidation teams dedicate 100% of their time to consolidation adjustments and results analysis Local accounting is corrected ensuring better financial information quality Transactions are perfectly auditable

Process optimisation: automation - to what extent and with what results?

Interco reconciliation is a complex process and many groups are trying to automate it.

The projects we are currently working on were initiated by clients who want to improve:

- **Productivity** (reduce the number of employees working on interco reconciliation and reduce the time they spend on it)
- Transaction traceability for better **auditability**.

Interco reconciliation, a complex and often poorly managed process

Intra-group transactions are often thought to be part of the consolidation process because they are eliminated at consolidation time.

The search for differences between intra-group account balances becomes the group consolidation department's responsibility and is often very tedious. This is because consolidators don't have access to the data sources. There can also be a number of reasons for the differences.

Among the most commons are:

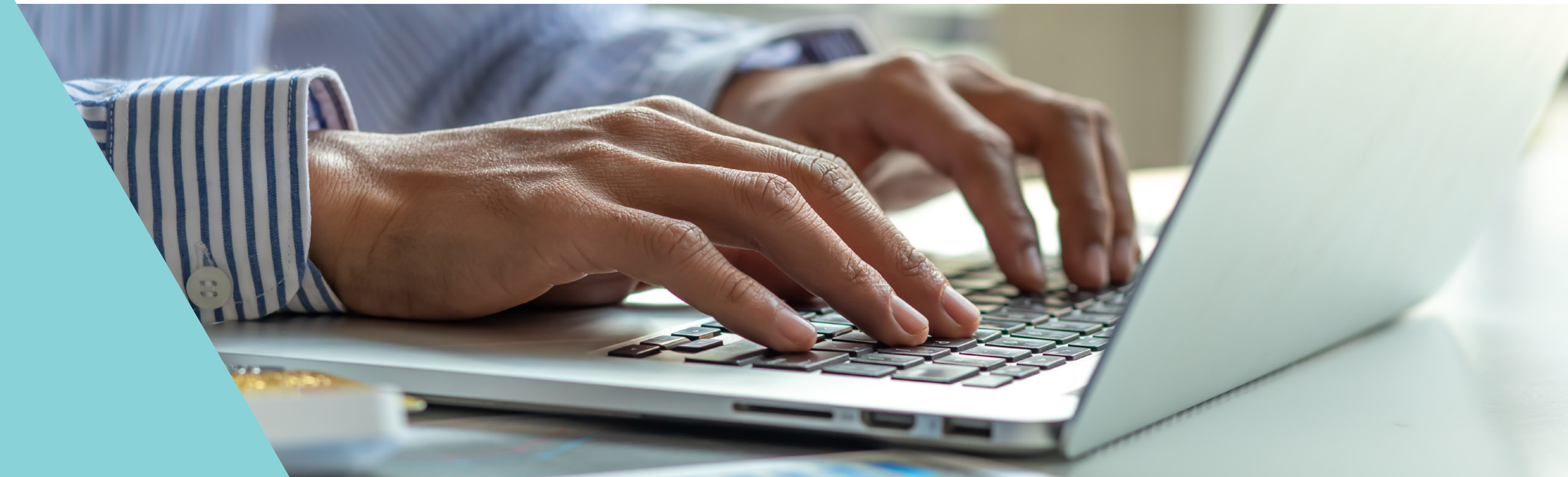
- Cut-off date discrepancies
- Different close dates
- The conversion of transactions initially denominated in foreign currencies
- Sales accounted for as a fixed assets at the purchaser's
- VAT paid by the purchasing company
- Rediscounting of debt with the banks
- Etc.

What do groups do today?

Some groups exchange Excel files among entities so that they can agree amongst themselves. All consolidation software packages normally provide intra-group account reconciliation functionality.

Consolidators have two options depending on the software:

- Either the consolidation software centralises the interco reconciliation process: the application automatically reconciles counterparty positions centrally. The tool calculates any differences at the account balance level. However, it is up to the consolidation department to coordinate the resolution of differences: email exchanges, sending of .xls files to try to resolve differences.
- Or the software provides a more elaborate module to reconcile intercos and give access to the entities. The consolidation department then has the option of decentralising dispute resolution and entrusting reconciliation to the entities. They can then reconcile amongst themselves. A data visualisation table enablesthem to view the positions of their counterparties. Reconciliation is done on the balance, in the transaction or local currency. The risk is that entities artificially align on their counterparty to make the interco difference disappear. This threatens financial data quality. Among other criticisms reported by operations: while the tools highlight the differences, they don't provide much help in justifying the differences (exchange differences, temporary differences, fixed-asset production, VAT impact, etc.). In addition, they don't always enable decisions that impact accounting data and enable corrections to local accounting information, if required. In the event of a difference, buyers and sellers exchange Excel files to try to resolve the differences via the transaction details. These file exchanges make audits difficult.



Reconciliation is done at the balance level in both instances. If the balance is different, the transactions are reviewed for the reconciliation. The risk is that certain transactions artificially reconciled by two entities “slip through”. The quality of the process and financial data obtained isn’t guaranteed.

The interco reconciliation process is done at consolidation process time in all of the cases we have just seen. In our opinion this is too late.

There is a third possible solution at the accounting team level. It involves implementing a dedicated interco account reconciliation application on a collaborative platform which enables transaction matching to speed up and improve reconciliation quality.

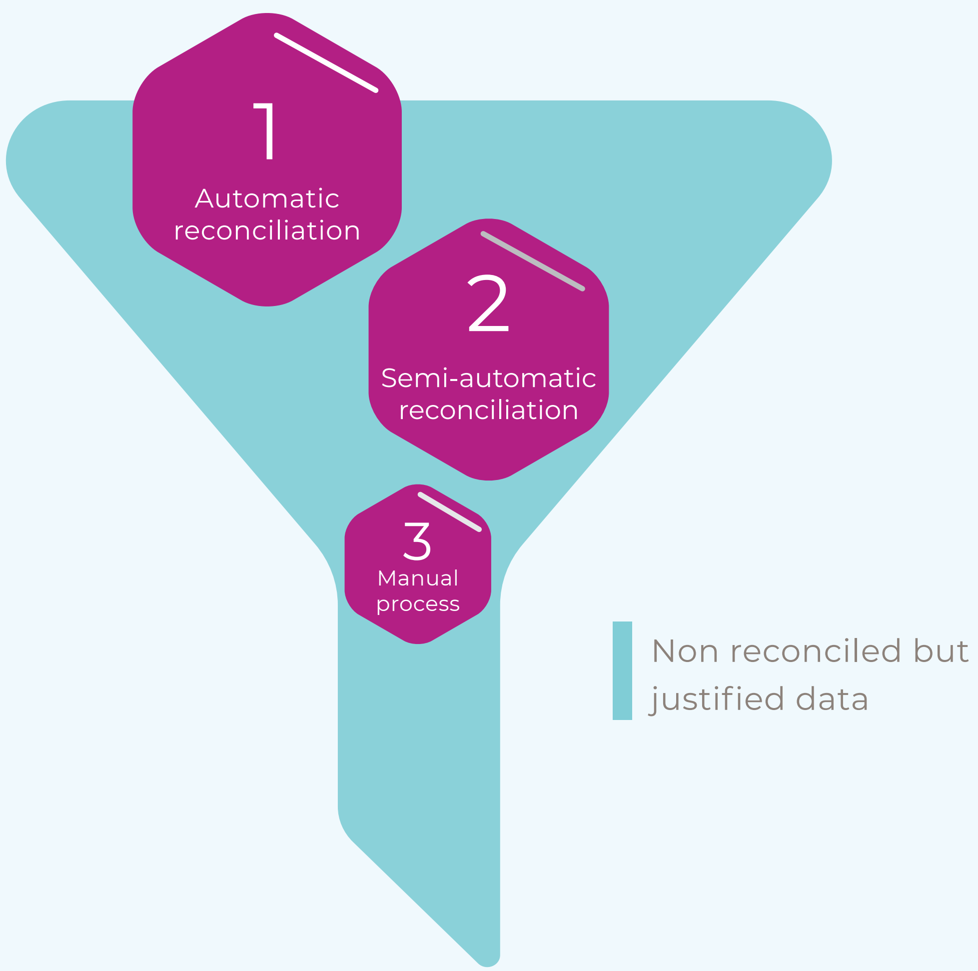
The idea in this case is to bring the interco reconciliation process down to the level of the entity which will use the tool for their accounting close. This means that the process is somewhat reversed. Instead of starting with the balance and working back to the transactions, reconciliation is done at the transaction level first.

From balance reconciliation to transactional reconciliation

A transaction-level intra-group reconciliation application makes it possible to:

- Match all closely associated transactions based on a list of predefined criteria (including materiality thresholds, currency variations, etc.)
- Send the data that couldn't be matched to the counterparties. The application assists the counterparties with the reconciliation
- Enable counterparties to use a collaborative platform to process data which can't be reconciled as is

The automation of interco reconciliation can be illustrated as a funnel:



1

Automatic reconciliation:

Matching: the tool works first at the transaction level: matching automatically reconciles as many items as possible. Automation is required because a group can quickly be faced with high volumes when working at the transaction level. For example, the software we installed at one of our client's automatically reconciles up to 97% of transactions. Only 3% have to be reviewed in more detail. The rate of automatic reconciliation at our clients' is generally about 70% to 80%.

2

Semi-automatic reconciliation:

The tool assists counterparties and provides gradual, assisted reconciliation: only transactions that haven't been reconciled are looked at. This step allows for matching or "marking by type of interco difference" using increasingly less restrictive criteria.

3

Manual process:

This yields only those data that can't be reconciled as is. The tool includes an interface to review even more detailed information about the transactions (local account, order number, store number, names, etc.) and a collaborative platform to help the entity with its research and, potentially, to attach accounting documents to specific transactions.

The interco reconciliation process becomes part of the accounting process and of the local accounts close, well upstream of account consolidation.

The process is iterative. The transactions are imported a first time. After automatic and semi-automatic reconciliation, the manual process can highlight local accounting errors which can be corrected. Transactions can then be imported a second time. Previously identified differences have been removed at this point (faulty accounting has been corrected!). The application creates a perfect audit trail between local accounting and the consolidated accounts.

Consolidators are no longer involved in analysing differences. This work is left to the accounting teams which have the knowledge and information required to document the reconciliation.

Interco reconciliation becomes an internal control tool and leads to an improvement in data quality and relevance.

In fact, when we refer to an effective intra-group reconciliation process, we need to remember that the final goal of reconciliation isn't to get to zero. This can lead to instances of "forced entries", a partner artificially aligning their accounts to be in sync with their counterparty. Where is the financial data quality? The process must ensure that everything that can be reconciled is, in fact, reconciled. However, in addition, it must be able to explain and justify the remaining differences: exchange differences, timing differences, accounting differences between income statement and balance, whether or not VAT is recorded, etc.

The group then has several options depending on its structure:

- Once the campaign is complete, the application can feed the balances into the consolidation software under consolidation team supervision. This will avoid re-entries and, in particular, ensure accounting data integrity throughout the process.

- Or, the consolidation tool can directly retrieve entity data from accounting (which are cleaned of all interco transactions and corrected if need be).

The consolidation team can enter the required adjustments.

Not all groups are ready to start working at the transaction level right away (heterogeneous accounting systems, etc.), so it's important that the system enable them to start working with balances. The system enables data centralisation and facilitates analysis. It ensures the exhaustiveness and perfect coherence of reconciled interco balances with those included in the consolidated accounts and, therefore, highlights any anomalies that wouldn't otherwise have been found.

Groups that opt for this interco reconciliation approach have all of the right cards in hand: intercos are reconciled and differences are justified before the close process starts. The close is done using reliable final data and is much quicker. During the audit phase, auditors are thankful for the time saved on research, discussions with consolidators and with group entities. All of the detailed information they need is available, including electronic exchanges with the counterparties in question, document exchanges, automatic or manual transaction marking…everything is traceable.

It's clear how an effective intra-group account reconciliation process can contribute to Fast Close.

Process optimisation: actions to improve the closing process

> Automation of the interco reconciliation process can provide an opportunity to review and optimise accounting close processes.

We offer a transaction-level intra-group account reconciliation software package that can be implemented over time (balance > balance, balance > transactions, transactions > transactions) to help improve group processes. Good practices are gradually implemented in the group via consistent entry rules for seller document references, seller issue dates, materiality thresholds, etc. Use of these new rules will later enable the optimisation of automatic transaction reconciliation...with significant productivity gains for the subsidiaries.

Here are a few other steps to improve management of intra-group transactions and optimise the reconciliation process:

- Implement a strict intra-group transaction posting schedule (cut-off dates)
- Standardise payment conditions across the group
- Set a deadline for interco invoicing
- Set a single exchange rate per currency within the group
- Handle disputes upstream in general sales and purchasing systems (property transfer definition, issuer rule, that is, adjustment on the "seller" position, escalation procedures, who is the arbitrator in the event of a dispute?)
- Identify the people involved, create a list of partners
- Increase reconciliation frequency

However, relying on software isn't enough. Change management for software implementation and its use by the entities is also crucial.

9 steps for efficient project management

We recommend that you set up a change management plan to make the project a success, with emphasis on the internal promotion of the project, so as encourage the entities to want the product.

1. Announcement to the entities: inform the entities about the project, the challenges it addresses and the expected benefits. You also need to make sure that you have the commitment and support of top management. Otherwise, the project is likely to fail.

2. Send a question list to the entities to gather for each entity or reporting unit the information necessary to build the conversion tables and the source files structures

3. Technical Installation of the interco reconciliation software

4. Training: administrator + key users at HQ

5. Process the information sent by the entities

   - Creation of the users, the structures, interco rules ...
   - Creation of the conversion tables and structures of the import files
   - In a large group, it might be useful to set up a workshop with a selection of key users (3 key users or so) at the reporting units to test and adapt the user manual.

6. Create the documentation and schedule the end-user training sessions

   - Set up the training collateral + the user guide specific to your group
   - Set up specific training exercises
   - End-user training

7. Real-life test using the data of an intermediate closing

8. Analysis of the comments received from the subsidiaries so as to improve the process. Draft a FAQ to improve forthcoming closing. And, if required, update the training manual or instructions manual. Send a report to the subsidiaries and the management of the group.

9. Go Live

About Prophix

Your business is evolving. And the way you plan your business activities and report on them should evolve too. To empower mid-market companies to achieve their goals, Prophix provides an integrated, cloud-based platform to the Office of Finance; one that delivers planning, budgeting, reporting, forecasting and consolidation solutions. With Prophix, finance leaders improve profitability and minimize risk and puts the focus back on what matters most – uncovering business opportunities. Prophix supports your future with AI innovations that adapts to meet your strategic realities, today and tomorrow. Over 2,500 active customers around the globe rely on Prophix to transform the way they work.

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