Multilateral Netting: an Essential Cash Management Tool?

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Multinational companies (MNCs) are often encumbered with huge amounts of transactions. Evidence shows that intercompany transactions especially are growing steadily; in some cases accounting for up to a third of all transactions. The increasing complexity of global intercompany operations requires coordination and alignment across departments. Shared responsibility and accountability are the main drivers towards an intercompany settlement process that is not only efficient, but also controlled and visible. This article examines the challenges, options, risks and benefits to be considered when setting up a multilateral global netting programme.

Since the Sixties the core process of netting has essentially remained the same. Settling intercompany invoices by netting has been in the market for decades and remains a very popular cash management tool. In its most basic form, a summary calculation is performed after all intercompany invoice data have been entered in a netting programme. This results in an overall position for each group company, which is then settled with the netting centre. Having only one payment amount per month reduces settlement risk and consolidates foreign exchange (FX) exposure with corporate treasury. From a business perspective, netting creates a disciplined approach to intercompany invoice settlement and allows group companies to forecast cash flows with more precision. The classical benefits relate to reducing transfer fees, loss of value days and FX transaction costs.

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Recent years have seen a shift in focus, from tangible to intangible benefits. In today's cost-conscious environment, the major driver is cutting cost within the group while mobilising cash resources in the most efficient way. There is a clear focus on improving payment discipline, creating a standardised process for intercompany settlements and integration with other treasury processes such as intercompany lending, cash pooling and FX exposure management. Handling intercompany transactions does not affect treasury only; tax and accounting also stand to gain. That's why we are experiencing a dramatic increase of involvement by all three stakeholders, resulting in a simplified and profitable working capital process. There are advantages for all departments, but only if and when they all chip in to get it right.

What is the Added Value for Tax?

Many companies still do not settle intercompany obligations frequently, on a regular basis. Some companies even settle their positions annually. As a consequence, intercompany balances accumulate on the balance sheet in the accounts payable and accounts receivable (AP/AR) system of the group companies. If those intercompany payables continue to grow over time, exceeding the normal payment terms, they could be considered intercompany loans from a tax perspective. This might induce tax authorities to impute an interest rate on that outstanding intercompany balance, resulting in a negative profit and loss (P&L) and a cash consequence. Such an intercompany loan from a foreign group company to a US group company could even be considered a deemed dividend. A tax consequence can be expected here too, the loan being viewed as repatriation of cash to the United States. Multilateral netting can help corporate treasurers avoid troublesome dealings with tax authorities.

Another area of great scrutiny for tax auditors is in the area of transfer pricing, generally thought of as a tax concept for the pricing of cross-border intercompany transactions between group companies. Netting, although rooted as a means to efficiently settle intercompany payables, is no longer focused on trade payables exclusively. It will also accommodate intercompany transfer pricing agreements, whereby corporate overhead costs are allocated to group companies. These costs can be related to global functions such as marketing, human resource (HR), procurement, insurance, IT license fees and legal, to name just a few of the most typical.

Often many of these global functions have been outsourced to the most cost-effective locations around the world. This results in a large number of multilateral intercompany flows that are typically settled on a regular basis. Global tax and accounting departments need to work together closely to document each settlement accurately to ensure compliance with both local and foreign tax rules. Bank Mendes Gans' own multilateral netting has proved to be very successful in tackling this requirement, and is generally accepted by most countries around the world.

Does Netting Improve Intercompany Accounting?

In MNCs with no formal netting process and no fixed intercompany payment terms, intercompany invoices can easily get lost in the day-to-day flow. If so, treasurers and others might wish to consider setting up an intercompany billing policy similar to that of regular third party payables. Once the process is defined, it needs to be designed and implemented efficiently so that group companies will be able to create payable files from their own enterprise resource planning (ERP) system. Even if various decentralised accounting systems are in use, it is relatively easy to put netting in place. The key to success will be a phased implementation that includes time for testing files in a dry run or 'mock' netting before going live. The next step is to build up experience with a limited number of group companies, and analyse the automatic intercompany reconciliation by matching open invoices against the payment file produced by the netting process. Once all stakeholders are satisfied that the requirements have been met and all transactions are processed and posted correctly, additional group companies may join.

Ultimately accounting might gain the most from having streamlined netting in place. Netting will drive efficiency throughout the end-to-end intercompany accounting process. It will also eliminate any discrepancies between the intercompany balances of the group companies and those of the head office. Netting ensures you are compliant; shows you are in control and will easily convince your external auditor.

Why is Netting Essential for Treasury?

Netting yields efficiencies and discipline around a set process, schedule and payment term policy. The treasurer benefits from the ensuing improved cash flow and working capital management. Netting feasibility studies demonstrate that while payable transaction volumes might be relatively small, the FX amounts can still be significant. A netting programme might therefore be justified, even if there are relatively few intercompany transactions. By managing FX exposures through a netting programme all group companies will benefit from attractive FX spreads negotiated by corporate treasury.

Best practice studies show that MNCs which manage their FX exposures through a centralised model tend to realise greater cost savings. The reason is that all group companies profit from highly competitive bulk rates that no individual group company could ever hope to bargain for alone. It is essential to determine carefully which currency to use when invoicing a buying group company; local currency might be best. This choice must be made in close cooperation with accounting and tax.

Netting provides the flexibility to perform multiple netting runs. This enables management to make real time decisions on the basis of accurate and up-to-date data. The netting settlement can be accomplished in many ways; through the group company's local bank account, via a simple payment transfer or a direct debit procedure or settled automatically by way of centralised cash pool accounts. These options give treasurers more control and visibility of cash movements than without a centralised approach.

Will Outsourcing Achieve the Sought-after Efficiencies?

Increasing numbers of MNCs express their interest in adopting a netting process, either through a third party service provider or managed in-house. Bank Mendes Gans has noted a growing number of spin-offs, whereby new companies are being established with integrated tax and treasury functions already working with outsourced AP/AR partners. Current trends show that global companies' high level objectives are to make the most effective use of available resources while minimising the additional staff required for non-value added processes. Often group companies that are sold or spun off were participating in a global netting programme of the former parent. Then management needs to evaluate, through a cost/benefit analysis, whether a netting programme is warranted under the new structure. If so, then additional cost/benefit analysis should decide whether the function should be insourced or outsourced.

Through discussions with many clients, we have learned that MNCs review existing netting programmes regularly to ensure that they are still optimising efficiencies. Typical questions include: can we substitute considerable manual workload by a fully automated process? Can we replace bilateral settlements by multilateral settlements? Can we implement a programme that allows for multi-currency settlement versus single-currency settlement, for instance in US dollars (USD)?

Finally, MNCs have a choice between in-house netting via a treasury management /ERP system or an outsourced netting approach. With the growing number of treasury projects on the roadmap, outsourcing transactional processing tasks might redefine the roles of all departments involved. Treasury, tax and accounting will be able to focus on monitoring and analysing the extensive netting reports while still being in full control of the end-to-end process. The mandate given to the selected service provider must, of course, be evaluated periodically from both customer satisfaction and performance points of view - such as are we sure that the external netting programme delivers the promised added value and are we saving costs compared to managing netting in-house?

If you want to keep improving the intercompany invoicing process, our recommendation would be to meet regularly with all stakeholders to explore opportunities. Watch for best practice, talk to colleagues and share knowledge. Treasury is a rapidly evolving area. And with the increased exposures that come with being a global company, it is imperative to have a robust system in place that easily accommodates the business process and yields control in the treasury environment.

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