



Enhancing value in a disruptive environment

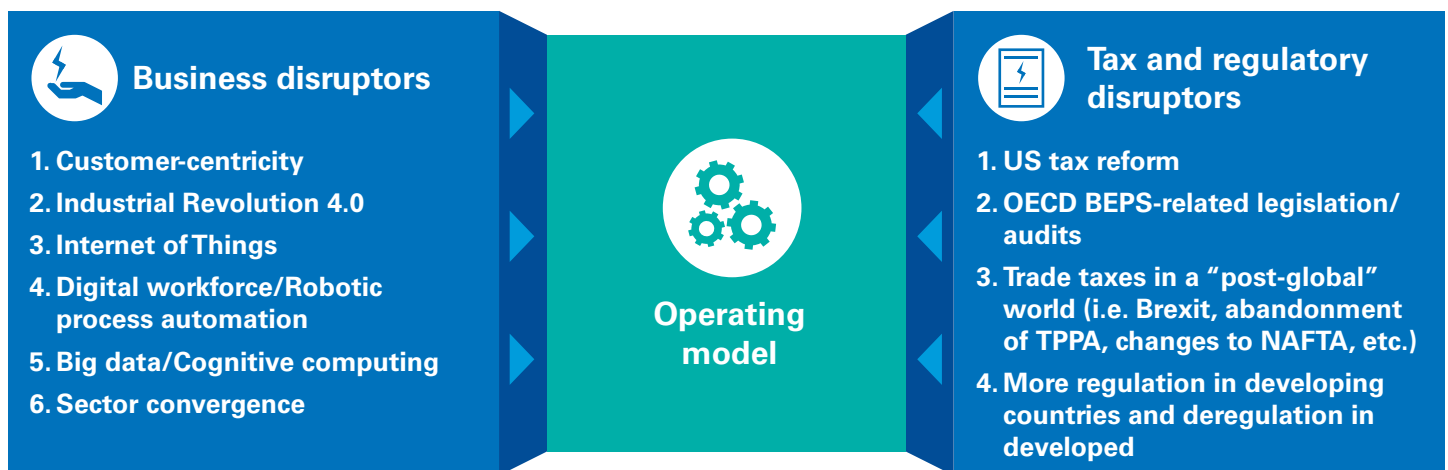
**As business changes, tax changes.
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Introduction

Faced with evolving customer behaviors, new and unexpected technologies, and shifting regulatory and tax policies, disruption is becoming business as usual for many organizations worldwide. In response, some companies are reevaluating both their value chains and operating models to better understand the ways in which disruption may be affecting how they can and should deliver business value.



Regardless of source, disruptors are catalysts for change in existing value chains. Complex interdependencies among people, processes, and systems require an integrated project team to help determine the operating model is viable and supported across the organization.

The reality in many organizations is that functional siloes, discrete business planning processes, misaligned key performance indicators, and other challenges can drive leaders to view disruptors as stand-alone problems to be addressed

in isolation — with strategy and operations focused on changes driven by business disruptors and the tax function focused on tax disruptors. Companies that view the required changes as unrelated organizational objectives may not be enhancing their

end-to-end value chain and may also be significantly increasing their overall tax risk profile. Organizations that can respond to disruptors in a fully integrated manner offer themselves a better opportunity to maintain and enhance enterprise value.

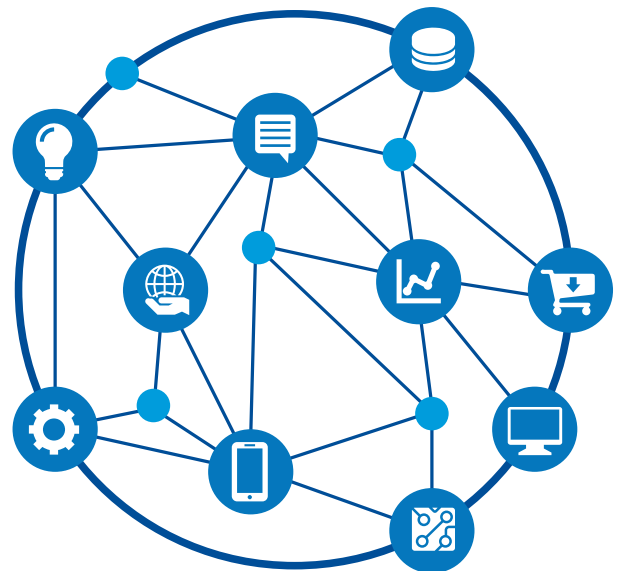
Value chains of the future: Highly integrated dynamic networks

The current economic era is increasingly characterized by always-on consumerism, customization, and same-day delivery.

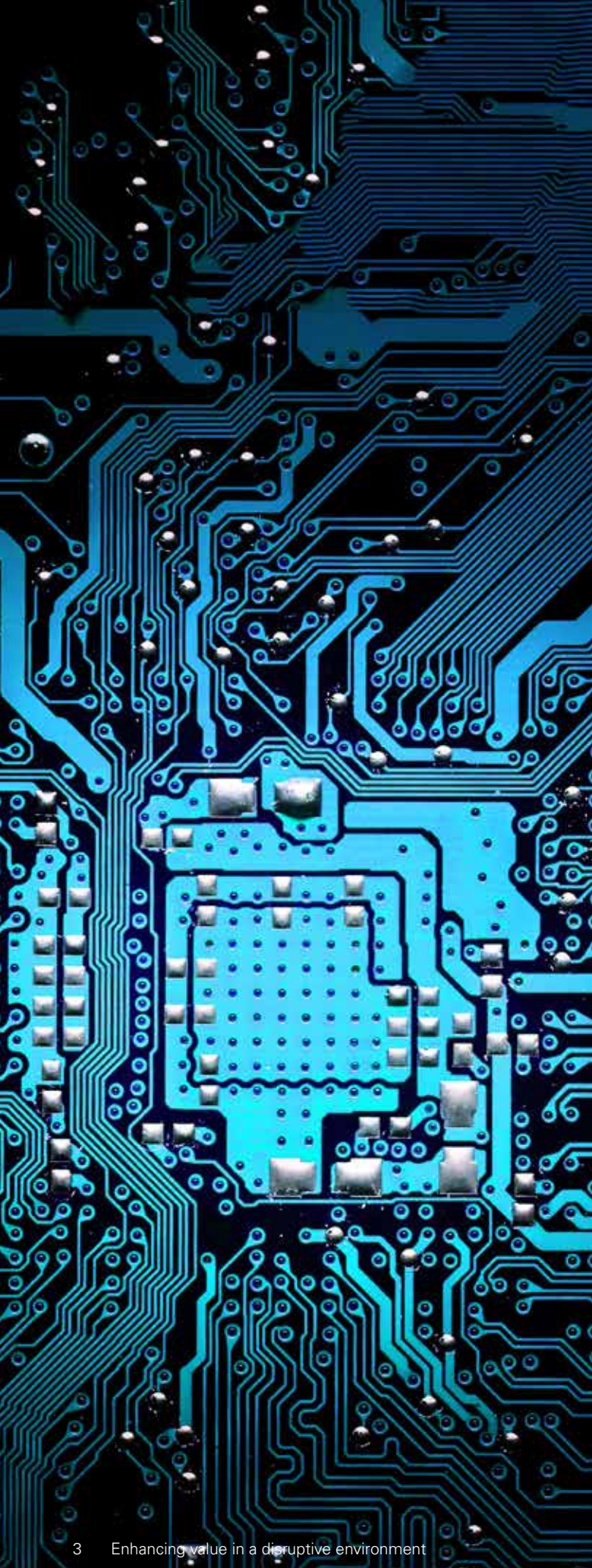
Organizations use e-commerce, digitization, and automation to be nimble and cost-efficient in response. Yet, these new demands and technologies also place new stresses on organizations' legacy operating models and open the door to competition from nontraditional parties.

Organizations are taking important steps to adapt to these evolving trends. KPMG's *2018 Global CEO Outlook* found that 86 percent of Chief Executive Officers said they are actively disrupting the sector in which they operate rather than waiting to be disrupted by competitors.¹ As business transformation drives change in the operating model and value chain, there is no guarantee that an organization will create value — indeed, in many cases, value may be reduced. As companies seek to leverage new technologies, they should seek to balance risk and reward specific to their industry and operating model.

Advances in technology are reshaping traditional linear value chains into dynamic networks.



¹ See KPMG 2018 Global CEO Outlook: Growing pains, available at: <https://home.kpmg.com/xx/en/home/insights/2018/05/ceo-outlook.html>



Despite variability across industries and across organizational maturity levels, KPMG has observed certain key trends:



Big data

Data sets have grown exponentially over the past decade — in part because data collection methods have proliferated via smart mobile devices, aerial sensors, software logs, cameras (closed-circuit television or mobiles), microphones, radio-frequency identification readers, wireless sensor networks, and other Internet of Things (IoT) devices. Availability of such very large and complex data sets enables advanced data and analytics that can spot “new” correlations to support business decisions. Conversely, organizations can become overwhelmed with the volume of data available. A rigorous focus on operationalizing new insights can help drive additional value capture.



Advanced analytics

The next generation of business intelligence and advanced data and analytics are yielding new and additional insights into customer behavior. Just as big data is providing new inputs for analytic engines, increased computing power is enabling real-time or near-real-time actionable insights from those inputs. Today’s technology also offers enhanced predictive capabilities with respect to customer and competitor behavior, as well as increasingly realistic “what if” scenario planning. Further, the expansion of self-service analytics and data preparation tools makes these new insights available more rapidly and to a much broader range of business users. Decentralization of analytics insights across organizations therefore presents both an opportunity and a challenge to enhance the returns possible through such new technology. Some leading organizations have established channels to connect relevant analytics with the key decision makers in the organization.



Industry 4.0

Process automation in and of itself is nothing new. The digitization of data, however, is leading to a new wave of process automation across multiple industries while also helping enhance efficiency, safety, security, and quality throughout the value chain:

Cyber-physical systems

Cyber-physical systems range from human-machine interfaces (HMIs) that control various processes via a touch display or central dashboard all the way to augmented reality systems supported by robots. Organizations have, in certain cases, been able to more time and cost-effectively deliver products and services to customers using newly available technology, such as high-quality three-dimensional (3D) sensors, haptic sensors, and 3D printers. The goal for HMIs is to improve efficiency (through decreased time to market, logistics costs, and lead times), security (through biometric recognition technology), troubleshooting and data collection, and health and safety for personnel and, in the long run, to provide significant cost reductions.

Artificial intelligence and machine learning

Algorithms that enable machines to learn new processes through data mining and pattern recognition are facilitating increased automation of decision making without direct programming. As machines learn to learn, organizations can leverage these new software technologies to help automate more complex tasks, identify potential problems in their value chain earlier, and, in the more advanced cases, resolve the issue automatically.

Digital labor and smart factories

Smart factories with mostly automated processes are being designed to leverage artificial intelligence and cyber-physical systems to help create an interconnected web of machines that can interact with each other, as well as with humans, to produce goods with an intended fraction of the human input than has been necessary historically. Machine learning is driving decentralized and automated decision making without the intervention of humans.

All of the above trends are helping drive a shift across industries from linear value chains with a static order to highly integrated and dynamic supply networks. Increasingly, products moving through the value chain can be freed from the set phased progression from supplier through to customer and, instead, each service provider in the value chain network can increasingly perform its tasks independently — regularly feeding data back into the network on a real-time basis. The anticipated resulting reduction in development, manufacturing, and distribution time can help drive additional operational savings. However, adopting the new technologies requires up-front capital expenditures and workforce retraining. These points should be considered up front as part of an organization's overall strategy in order to rightsize the investment and help enhance return on investment.

As is common to transformation initiatives, companies that are able to reorganize their value chain around emerging technologies can fundamentally alter how and where value is created in their organization. For example, by automating a series of manufacturing processes, a company is shifting the relative contribution to the final product away from the manual labor that historically assembled the product and toward the know-how and intellectual property (IP) embedded in the computer code, which drives the automated decision making and assembly of the products in the new model. Understanding how value is created in an organization, both today and in the future-state operating model, is not only critical to successfully aligning strategy and operations but also to enhancing the potential tax implications of organizational transformation efforts.



Tax and regulatory disruptors: Change on a global level

While tax is often seen as country-specific, new norms are developing on a global level that are reshaping many nations' tax systems. In an increasingly interconnected world, national tax laws generally have not kept up with globalization and the rise of the digital economy, and this disparity has accelerated capital mobility.

Many tax policy makers believe that this misalignment has resulted in “base erosion and profit shifting” (BEPS) — that is, exploitation of mismatches in international tax laws that results in unsubstantiated allocations of profit to low or zero-tax jurisdictions.

As a result of these concerns, the Organisation for Economic Co-operation and Development (OECD), whose members include dozens of the world's largest and most advanced economies, worked closely with the G20 government forum and other interested stakeholders over the last three years to create a comprehensive new framework and set of guidelines to combat BEPS. A common theme through the ongoing development and adaptation by countries of these guidelines has been a push to change the way companies allocate profit among multinational group members, along with a drive toward transparency so that tax authorities can better understand and critique the rationale for such allocations.

Generally, and prior to the issuance of the new OECD guidelines, cross-border tax planning relied heavily on the location of the group entities that legally owned IP

and assumed key business risks through intercompany contracts. Under this framework, multinationals may have striven to assign lesser “routine” profits to operating companies and larger “residual” profits to the entity legally owning the IP rights and/or underwriting the group risk. Such planning may have been performed independently of an assessment of the enterprise-wide value chain. The OECD guidelines suggest profit allocation ought to be more closely aligned to the economic value drivers in the value chain. The contractual allocation of risk (and hence profit) to an entity in a low-tax jurisdiction performing no actual functions in the value chain may not be defensible under these new standards. Instead, a much more robust analysis of a company's value chain and the profit-driving functions, assets, and people within it (e.g. workforce, factories, retail stores, data centers) may be required to justify the allocation of “routine” and “residual” profits to different group entities.

Furthermore, other assets — including those more mobile assets, such as legally protected IP or other intangibles (e.g. trade secrets and contractual rights) — may not



necessarily be given as much weight in assessing where value is created, particularly if separated from people or physical assets. Accordingly, the fact that IP or trade secrets are “owned” by a subsidiary located in a particular jurisdiction may no longer mean, in and of itself, that meaningful profits would be respected as attributable to that jurisdiction.

In this way, BEPS has effectively helped redefine the concept of “value creation” and the application of the arm’s-length standard to allocate profits among affiliated companies in the eyes of tax authorities globally. These changes, coupled with the increased demands for greater transparency and the focus of many jurisdictions on “make local, buy local” tax and trade policies, are causing multinationals to consider the need for in-depth value chain and operating model reviews.



The big idea...

Increased disruption to operating models across industries and the global tax and regulatory environment drive the need for business transformation and increase the complexity of such initiatives. KPMG teams have the industry and technical knowledge, along with the execution capabilities, to help your company effectively deliver the value promised and navigate the rapids from strategy through execution. Further, by utilizing a value delivery framework in their approach to help drive an integrated concurrent approach to business and tax planning, the KPMG network of professionals can help enable companies to deliver on that promised value.



In practice...

A global logistics and third-party logistics operator undertook a large transformation project to help it better compete against new, more agile market entrants. Working with its advisers, the company estimated it could drive valuable process improvements and recognize potentially significant cost efficiencies by realigning its operational network and managerial oversight teams and updating its procurement operations and supplier network. If, for example, the additional savings were generated in a country with a 30 percent tax rate, 30 percent of the savings would immediately be lost — that is, the operating expense savings would be reported as additional taxable profit, subject to the 30 percent tax rate. By including tax, trade, and treasury considerations in the design of the new target operating model (TOM) (specifically by structuring the operating model to conduct value-creating business activities in more tax-competitive jurisdictions), the company was able to retain significant savings while improving its working capital turnover ratio.

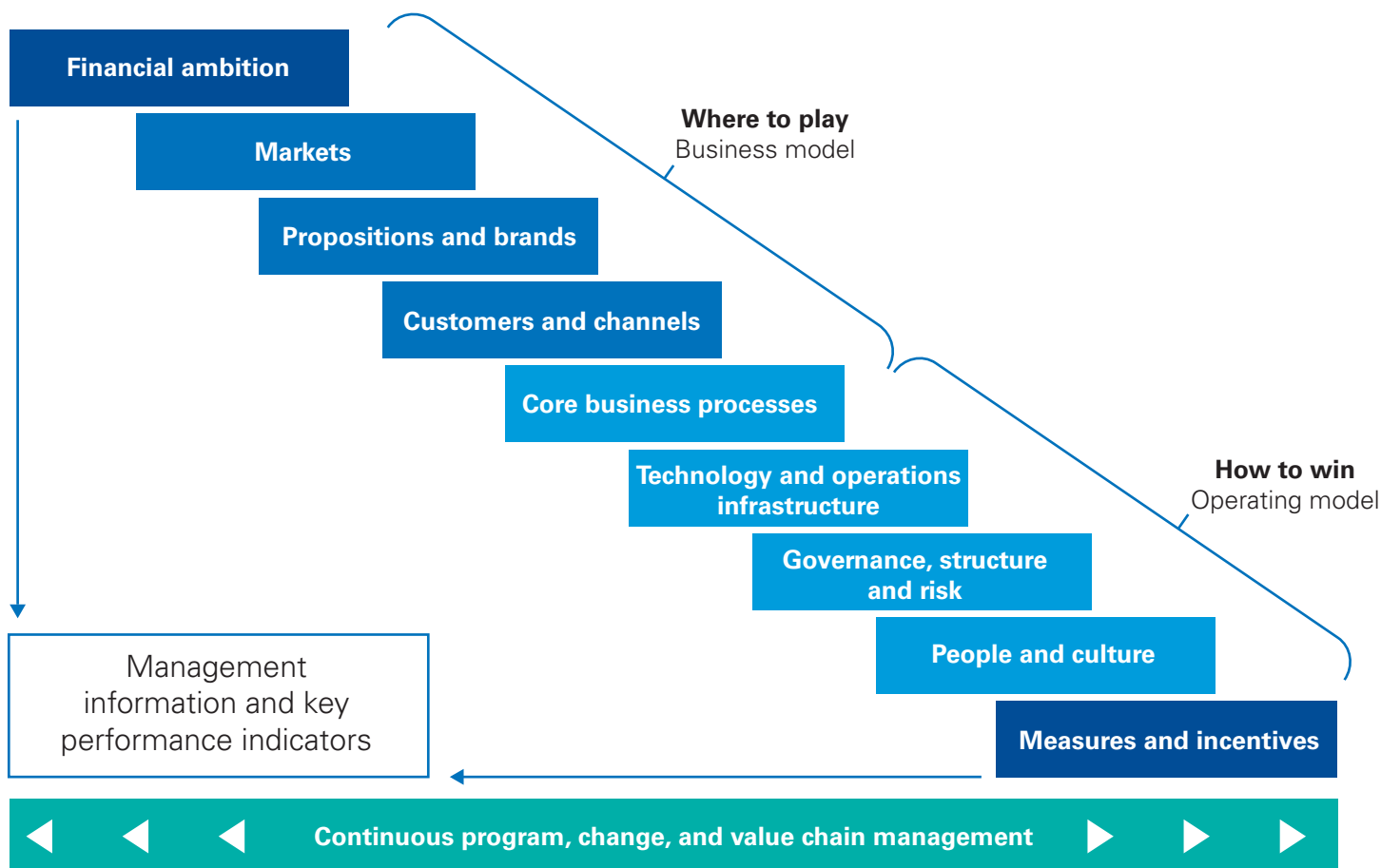
Similarly, a leading multinational technology original equipment manufacturer performed an in-depth review of its value chain, which had been designed 15 years prior. By redesigning its TOM with input from tax, trade, and treasury, the company was able to restructure its value chain to comply with the recent guidance from the OECD’s BEPS initiative, mitigate future tax risk in its structure, and achieve a significant reduction in annual operating expenses.

Identifying your organization's value drivers







The KPMG Global Strategy Group uses the 9 Levers of Value as a frame of reference that assists companies in understanding the range of value-creating activities that organizations undertake and where a company can (or should) focus its transformation efforts. The 9 Levers of Value enable a company to take a holistic view of its value chain and better ensure that critical value-driving functions

are not overlooked or undervalued. Companies can help enhance the impact of a value chain analysis by evaluating and understanding the value chain as not only how it exists today but also how it may exist in the future. When an organization has a clear view to how they currently drive value, they are better positioned to understand how those value drivers can be refined or altered to adapt

to tax and regulatory changes or to capitalize on new technologies. Further, this process often uncovers additional business intelligence (BI), potentially revealing joint operational and financial opportunities for improved efficiency, operational cost savings, and customer satisfaction, and also enables a clearer view to the organization's risk profile (strategic, operational, and tax).



Similarly, a value chain analysis is a powerful tool in documenting value creation in an organization under the new BEPS guidelines. Whether undertaken for operating model or tax structure enhancement, a value chain analysis can help uncover an organization's value-driving activities. KPMG professionals have developed a standardized value chain analysis process, which includes review and analysis of third-party data, the development of a value hypothesis, and focused interviews to:

-  Prepare a "process map" — Capturing activities across a value chain
-  Identify and map assets and risks — Mapping assets and risks to specific processes
-  Prepare functional analysis — Documenting how and where key activities are performed
-  Evaluate assets and risks — Assessing role and relation to key processes
-  Prepare "heat map" — Identifying relative weight of value-creating activities
-  Overlay entity perspective — Matching processes to legal entities/location



As business and tax disruptors accelerate the need for new operating models, companies need to plan and execute fully integrated solutions if they are to enhance value and compete effectively in a rapidly evolving business environment.

KPMG firms are comprised of globally integrated, multidisciplinary teams that bring together the full spectrum of capabilities, including strategy, management consulting, risk, tax, trade, and treasury, to assist clients undergoing transformational change. By integrating the web of business, tax, trade, and treasury considerations into a single value delivery framework (VDF) and supporting

that framework with integrated methods (e.g. strategy, TOM, and information technology), KPMG teams can help businesses identify risks and opportunities in their existing value chains and operating models and then help design and implement innovative, integrated solutions that enhance value in a sustainable manner.

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