ITALY

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How to manage ESG, value chains, and transfer pricing considerations

Carola Valente of Crowe Valente/Valente Associati GEB Partners explains why ESG goals and requirements are intertwined with transfer pricing, and how multinationals can mitigate the associated risks throughout value chains

ESG considerations are transversal in all value chains and impact not only companies captured within the threshold set forth in new regulatory initiatives such as the Corporate Sustainability Reporting Directive (CSRD) but also SMEs.

SMEs play a vital role in the value chain of larger companies, serving as suppliers, subcontractors, or business partners and providing goods or services. With the introduction of the CSRD, SMEs will be required to disclose and adhere to sustainability standards set by the large enterprise they collaborate with.

Major corporations and multinational organisations already demand their suppliers meet specific ESG criteria, including environmental standards, ethical labour practices, and transparent policies.

Non-compliance with sustainability requirements not only exposes SMEs to legal and financial risks but can also result in their removal from the supply chain, leading to significant social consequences. On the other hand, adhering to these standards opens up substantial opportunities for development throughout the value chain.

Due to the impact of ESG considerations within the value creation process, transfer pricing plays a key role and cannot be left out.

This article explores the relationship between transfer pricing and ESG, and how its interconnection can help to foster a more sustainable approach within multinational groups.

Functional, assets, and risk analysis

Companies should conduct a comprehensive assessment of sustainable development goals. This usually involves the creation of a sustainability risk exposure map throughout the value chain, taking into account a company's geographic presence and key markets risk (focusing on environmental risks, risks related to governance issues, or social-related risks).

Furthermore, it is important to understand the contributions made by the company throughout its process and whether they are aligned or misaligned with sustainable development goals.

Considering the above, transfer pricing policies and documentation need to adapt and cope with ESG considerations.

Functional, assets, and risk analysis requires a detailed ESG analysis, so as to clearly identify:

- New transactions deriving from ESG topics;
- Potential changes to the company business model;
- The potential impact on, or changes to, the brand value or intangible property of the company; and
- Changes to the value chain operating models.

Functional analysis

The scope of the functional analysis should include the evaluation of ESG-related functions conducted by each entity, such as:

- The identification and documentation of tasks related to environmental conservation;
- Social impact;
- Corporate governance compliance with environmental regulations;
- Sustainability reporting; and
- Employee welfare programmes.

The functional analysis will need to determine whether the costs incurred by one or more entities in the group provide benefits to other companies in the group. In such a case, a recharge of such cost, plus an arm's-length mark-up, should be evaluated.

Assets

In terms of assets employed, it is essential to identify the tangible and intangible resources that play a role in generating value within the ESG area, which might include:

- A change to renewable energy infrastructure;
- Patented sustainable technologies;
- Trademarks associated with environmentally friendly products; or
- A company's reputation for ethical business conduct.

Investments in ESG activities will be able to bring benefits to the value of the group's intangible assets as well. In such cases, a detailed DEMPE analysis could help in the allocation of profits or costs between the group's companies.

Risk

It is important to focus on the identification and evaluation of the potential influence of ESG-related risks on the financial performance and value generation of companies within a group. ESG-associated risks might relate to:

- Climate change;
- Ethical considerations within the supply chain; and
- Regulatory compliance in ESG-related sectors.

Traditionally, these risks could be collectively categorised as reputational risk.

The implementation of ESG initiatives cannot be conducted in a siloed environment within a company or a group, considering its impact on a company's profit allocation and transfer pricing model.

An Italian perspective

Italy, like many countries, has been integrating ESG principles into its business landscape.

Companies operating in Italy are expected to align their transfer pricing policies with ESG goals, not only to comply with regulatory requirements but also to contribute positively to the environment, society, and governance in the country, and avoid potential risk exposure.

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