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Sarbanes-Oxley Section 404 and The Tax Department You've Finished Your Sarbanes-Oxley 404 Documentation and Assessment – Now What?

By Michael Guelker, Vertex Inc.

By now, you have all heard the hype and teeth gnashing about the Sarbanes-Oxley Act – in particular Section 404. As Gary Paice from Ernst & Young pointed out in his Spring 2004 article, implementing Section 404 is one of the most involved processes companies are facing today.

This article discusses how companies can think long-term and capitalize on their 404 efforts. Specifically:

- What's been happening in the marketplace related to the PCAOB and tax;
- How many of you have either completed your 404 efforts or are in the final stages;
- How to capitalize on the momentum and reap the harvest of your hard work;
- What are your concerns over the efforts required to take the next steps after 404 compliance;
- How a real-life taxpayer capitalized on his efforts; and
- How not to let your 404 compliance efforts go to waste.

PCAOB Activity and Tax

The official description of the Public Company Accounting Oversight Board (PCAOB), or Peek-A-Boo as they are often known, is "A private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports." Recently, the PCAOB held an Auditor Independence and Tax Services Roundtable on July 14 in Washington DC.

This day long session was focused on what non-audit services public company auditors could provide to their audit clients. The participants in the roundtable were a varied group ranging from the Big 4 to smaller regional firms, Fortune 500 taxpayers, and large institutional investors such as CALPERS as well as the IRS and the SEC. Needless to say, the opinions were varied as to what services auditors could provide to their audit clients, but the main points to be taken from the roundtable were:

- No changes are proposed at this time to further limit the services auditors can provide their audit clients other than those prohibited by the Sarbanes-Oxley Act;

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- There is quite a bit of focus on tax shelter activity and the promotion of those by audit firms; and
- Over a three-year period, there has been a significant reduction in the amount of non-audit fees paid to audit firms.

There is no doubt that these topics will continue to be in the limelight as more and more active institutional investors keep the pressure on to further separate audit and non-audit activities and fees.

Another PCAOB activity pertaining to tax is the recently completed PCAOB Limited Inspection of Big 4 audits to address performance and quality control. The PCAOB made some of their results public on August 26 and some of those results relate to tax:

1. Failure to identify or address GAAP exceptions
 - a. PCAOB discoveries resulting in financial restatements by the issuer
 - b. Other GAAP exceptions
2. Departures from PCAOB standards and the Firms quality control standards
 - a. PCAOB discoveries that lead to additional procedures by the Firm
 - b. Departures other than documentation deficiencies
 - c. Additional departures concerning documentation



With respect to tax, all Big 4 firms had at least one issue related to tax items. Since this was an inspection of their audit performance, all of the tax items related to the income tax provision. The schedule below gives a recap of the tax issues noted by the PCAOB.

ISSUE	KPMG	EY	DELOITTE	PWC
Staff Discoveries Resulting in Restatements by Issuer	0	0	0	0
Other GAAP Exceptions	1	0	1	0
Staff Discoveries That Led to Additional Procedures by the Firm	1	3	0	1
Departures Other than Documentation Deficiencies	0	0	0	0
Additional Departures Concerning Documentation	0	1	0	0

NOTE: There is a section of the PCAOB reports that was not made public, so those results are only known to the PCAOB and the Big 4.

These items are highlighted not to condemn the Big 4 in their audit practices, but to raise the point that tax is an integral part of the financial statements and the audits and has the attention of the PCAOB.

Where Companies Stand Today

Given that a majority of the taxpayers are on a calendar year-end, we are coming into the homestretch of 404 compliance. Using the common standards of the 404 Life Cycle as a guide, most companies should now be in the Testing and Remediation phases.

1. Educate
2. Prepare
3. As-Is Assessment
4. Gap Analysis
5. Testing
6. Remediation
7. Continuous Improvement



As Gary Paice pointed out in his article, the 3rd and 4th quarters of this year should be devoted to the Testing and Remediation phases. Those who are waiting until the 4th quarter to test controls

for the first time, will be in an awkward position if internal control deficiencies are noted during the testing phase.

An informal survey done by Vertex shows that the majority of taxpayers are either testing their internal controls now or are performing remediation efforts related to those controls, thus confirming Gary's position.

The bottom line is that the best functioning tax departments are now focusing on the Testing and Remediation phases of Section 404 and are well positioned to be ready for their auditors in early 2005.

Other interesting aspects of the survey include:

- Nearly half of the respondents agreed that senior financial managers or executives have gotten more involved in the tax department operations and procedures as a result of Sarbanes-Oxley.
- Over half of the respondents have introduced process automation initiatives as result of Sarbanes-Oxley.
- About a quarter of the respondents said the tax department's relationship with the Audit Committee has changed due to Sarbanes-Oxley
- About one-third of the respondents said their tax department's relationship with the Internal Audit Department has changed due to Sarbanes-Oxley

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Capitalize on the Momentum

It would be a shame to let all the hard work that you completed during the past several months go to waste and only serve as a compliance effort to satisfy the auditors. You must seize the moment and capitalize on the momentum.

There are a few factors that allow you to take advantage of the 404 work and help improve the processes and technology within your department. For example:

- A lot of the leg work is already complete
 - Gap vs. Desired State
- Documentation is complete
- An opportunity to rethink the processes
 - Can it be done a better way?
 - It's fresh in everyone's mind
 - There is something tangible there
- There may be budget dollars allocated

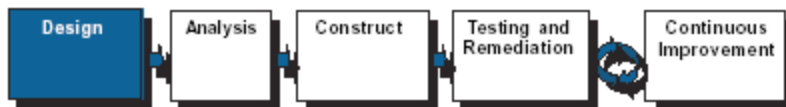


If you again go back to the Section 404 lifecycle, you can see parallels in the methodology used to comply with 404 and those used to perform tax optimization and automation projects.

Section 404 Lifecycle



Tax Optimization and Automation Methodology



You can capitalize on the documentation work and As-Is Assessment that has been already completed by having that serve as the springboard for your Design and Analysis phases of the optimization and automation projects. Many of my clients who have gone through an extensive amount of documentation in many major areas of their tax departments want to be able to use that work-product not only as a compliance requirement for 404, but also as the starting point for re-design efforts in their departments.

Another advantage of using the work performed for the 404 compliance is that it's fresh in everyone's minds. This is a great time to capitalize on the collective effort of everyone involved. While the compliance efforts for 404 might have been a laborious experience for some, you can bottle that knowledge and put it to good use to make your department more effective and efficient.

Additionally, there may be some money floating around. Companies are spending an inordinate amount of money to comply with 404. If you can show how you can use the effort expended along with some incremental spending to produce a favorable ROI, then the efforts of 404 will not go to waste on pure regulatory compliance.

Concerns of the Effort Required

I have spoken to many clients and one of the common themes of our discussions is how taxed (no pun intended!) they are with all of the responsibilities they have on their plates. Many of you have just completed an exhaustive 404 documentation effort coupled with filing federal and state income tax returns, not to mention the other day-to-day duties a tax professional faces. Going back to the Vertex informal client survey, over 75% of the respondents indicated that their departments did not add additional resources to comply with the 404 requirements. A TEI survey also indicated that 85% of the respondents were not allocated any additional resources or budget dollars for the 404 efforts.

Despite the glum news, there is hope out there. In this competitive environment, where discretionary budget dollars are hard to come by, you have to be creative to get the purse strings to open. The most effective way I have seen tax departments obtain budget dollars is to effectively prove a positive ROI. Most of the companies indicate that in order for a project to get approved, it must pay for itself within 1-2 years. The most effective ROI is either a reduction in the effective tax rate, staff reductions, shifting of resources from compliance to planning, or reduction of taxes that go right to the bottom line (e.g. consumer's use tax, etc.).

The ROI calculations are relatively simple and easy to explain to senior

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management. The most common calculations are:

Total Investment/(Total Savings/12) = Payback Period in Months

Internal Rate of Return; Use MS Excel's IRR function to calculate

The trickiest part is calculating savings in such an esoteric field as tax, but it can and has been done in the past. You just have to be confident in your numbers and be able to show how by using process changes and automation, you can effectively shift resources from compliance to planning and that those resources are going to generate tax savings that are going to drop right to the bottom line.

A Real-Life Example

Here's a real-life example of a taxpayer who utilized his 404 compliance efforts and was able to secure funding to improve and automate their tax provision process.



This taxpayer went through a rather vigorous 404 readiness exercise in his income tax provision area. The results of the 404 exercise were that while the process was well documented, it was an extensive manual process that relied on an inordinate number of spreadsheets and manual keying and re-keying of data. It became evident to the tax director that while his provision process would pass muster with his auditors related to 404, it was time to do something to improve the process and further automate it.

The tax director set out to build a business case to secure funding to improve the provision process from beginning to end. In order to effectively sell his business case to upper management, he built his case on two major premises:

- Use of his tax software vendor's package to significantly reduce and/or eliminate the spreadsheets; and
- A re-design of the entire process.

These two building blocks enabled him to show a favorable ROI and IRR by:

- Reducing the time it took his staff to perform the provision calculation;
- Eliminating the errors resulting from heavy spreadsheet and manual keying aspects;
- More accurately forecasting estimated payments to reduce the company's payments to the IRS and the states; and
- Taking advantage of the time value of money.

One of the key items he used to show how spreadsheet usage is open to errors is the whitepaper from PricewaterhouseCoopers titled "The Use of Spreadsheets: Considerations for Section 404 of the Sarbanes-Oxley Act". This whitepaper points out the high error rates in spreadsheets and gives some real-life examples of how companies lost real dollars due to those errors. I'd encourage everyone to get a copy of this from the PwC Web site; www.pwc.com.

By being proactive and building an effective business case with favorable ROI, your 404 efforts will not go to waste and you can build that world-class tax department you've always wanted.

With a little hard work, help from outside sources, credible statistics, and concrete savings calculations, this tax department was able to take their 404 efforts and expand upon them to bring about real change to become more efficient and add to the company's overall bottom line.

Don't Let Your 404 Efforts Go to Waste

It is possible to use your 404 efforts for something other than an audit guide for your outside auditors at year-end! With the increased focus on tax due to Sarbanes-Oxley, it is conceivable to make the necessary process and automation changes in your department so that your department is more effective and efficient and that your changes contribute to the company's overall bottom line. By being proactive and building an effective business case with favorable ROI, your 404 efforts will not go to waste and you can build that world-class tax department you've always wanted.



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