The Future of Tax Operations, Part III

Taking the First Step

Best Practices for Tax Transformation

WHERE TAXATION MEETS INNOVATION

Executive Summary

Tax transformation – it's a hot topic that raises lots of questions among tax executives. To help provide guidance on how to start the process and ensure a successful outcome, Vertex hosted a webcast in September, 2011 featuring leading tax consultants from the Big 4:

- David Landers, Tax Management Consulting, Deloitte Tax LLP
- Robert Guarnieri, US, Tax Performance Advisory, Ernst & Young
- Albert Lee, EMEIA, Tax Performance Advisory, Ernst & Young

Moderated by Vertex's Vice President of Customer Relationship Development, Jack Ferraioli, the webcast was the third installment in the "Future of Tax Operations" series. The panel explored best practices and provided recommendations based on experience with tax departments around the world. We've summarized the discussion here in a Q&A format.

You'll find answers to questions such as:

Q. What is tax transformation?

A. Broadly stated, tax transformation is a process designed to evaluate and improve all aspects of tax operations across all jurisdictions and processes. The goal is to align the Tax department with the goals of the larger organization and make Tax a strategic contributor to the company's overall direction. In that respect it's both a process and result.

During tax transformation, companies evaluate all of the building blocks involved in the tax lifecycle, including the data that's needed, the technologies in place, the processes supported by that technology, and the people who engage in these processes. Processes analyzed typically include, among others:

- The initial recording of transactions by operations
- The tax data collection and validation process
- The provision process
- The transfer pricing process
- Financial statement auditing processes
- Estimated payments and returns processes
- The return-to-provision process
- Tax examinations
- The tax basis balance sheet

A gap analysis – which compares between the desired state and current state – forms the basis for the tax transformation roadmap.

Q. What does a "transformed" tax department look like?

A. By changing processes to address gaps, the transformed tax department can operate as a strategic advisor and contributor to business operations, and proactively influence the overall direction of the company. For instance, when management is evaluating new markets or new product lines, Tax can strategically recommend the associated changes so that they occur in a tax-efficient and risk-controlled manner. In this way, Tax is actively managing risk through preventative controls.

In addition, with tax transformation a company is better positioned to handle internal and external change. Internally, a transformed tax department can handle the changes because it has flexible, automated processes that can be adapted swiftly, as needed. Externally, your company faces a hyper-regulatory environment that demands ultra-transparency – both on the financial side (with the SEC) and the tax auditor side. In fact, auditors are looking beyond data to understand the processes that use data and how systems connect to underlying data sources.

With a transformed tax department, you have optimized and documented all processes and data sources so there's reduced audit risk.

A transformed tax department can also provide forward-looking quarterly business forecasts and even after-tax forecasts. While this may not be necessary for all companies, the possibility is intriguing because there is proper alignment of people, processes, data, and ultimately technology.

Deloitte Tax LLP Partner David Landers notes, "A transformed tax department is no longer chasing risk fires. They're managing risk through a more preventative control versus a detective control. They're positioned to be able to handle the changing business environment; whether that be an internally changing environment, or externally. A transformed tax department is ready to handle, and be quick to adapt to those changing needs."

Q. How do you build a business case?

A. The tax transformation process is made up of inter-related pieces, and they must come together to form the whole picture. Like a jigsaw puzzle, it's much easier to complete the puzzle when you actually have the picture on the front of the box – in other words, a picture of what the end result should look like.

True transformation looks across the entire organization and eliminates standalone processes that may be focused in a particular area, like provision or compliance. More than simply a tactical project, tax transformation is designed to break down barriers between Finance, Tax, and IT.

Building a really good business case, one that actually gets approved for a multi-year, multi-million dollar tax transformation initiative, is an art and a process. So before you start, talk to tax peers, industry peers, company-size peers, who have been through these types of initiatives before to learn from the mistakes they've made, avoid some of the pitfalls, and find out what worked for them. Throughout the process, ask *"What are we going to accomplish? And why are we trying to accomplish this? Why is it important?"* Be clear and be concise and clarify what you won't do.

Remember that tax transformation is not about headcount. Avoid letting the business case become very headcount-focused. The average cost of a U.S.-headquartered tax department is typically less than a penny per earnings per share – and yet Tax typically manages 30-40% of the company's total expenses.

Instead, focus on benefits such as:

- How tax transformation will help lower tax liabilities, reduce cash holdings for taxes, and better manage provision processes. The benefits in these areas total to much more significant numbers that will catch the attention of c-level executives
- The potential cost and efficiency improvements from an operating perspective
- The impact tax transformation will have on the financials of the organization – including the ability to make better investments and planning decisions that boost the bottom line

> "Tax transformation is not just about technology or process. Ultimately, the people interacting with all parts of Tax need to be willing and able to help drive change."
>
> \- Robert Guarnieri, Ernst & Young

Q. Who should be involved in the initiative?

A. Tax transformation doesn't happen in a vacuum. You need to collaborate with other departments – including Finance and IT – in order to be successful. So your business case needs to convey the value to their respective organizations and to the business overall. It's important to be bold and think big – since you're asking for a transformational change and a sizeable budget and resource commitment. Your colleagues will ultimately measure the total cost-benefit of what you're proposing based on the overall value proposition to the business.

For the IT Department, tax transformation means supporting new tax technology as business-critical systems enabling key processes such as provision and compliance. So you'll need to discuss service level agreements, and IT policies, like the use of hosted applications. By starting conversations about these types of topics, you can speak the language of IT and collaborate to get the support and resources needed to facilitate transformation.

For the Finance Department, tax transformation is an opportunity to standardize how IT supports Tax and thus enable the success of Finance transformation initiatives. For example, there can literally be thousands of interactions and data handoffs between Tax and Accounting that can derail finance transformation if the processes around them are manual and inefficient, or if information must be restructured for tax personnel.

By deploying a tax data warehouse, a foundational step in any tax transformation, Finance and Tax increase efficiency by centralizing all tax-relevant financial detail in real time, in the right format, in one place, so the right people can access it as needed. Additionally, because Finance teams no longer need to deal with a myriad of one-off requests for information by tax professionals, they can stay focused on servicing different areas of the business and meeting compliance requirements. At the same time, Finance has instant access to tax-related data needed to support better planning and decision making, proactively identify tax-related business risks, and more.

It's equally important to get Finance thinking honestly about the company's current level of control over global tax obligations and the level of complexity involved. For example, explain the complexities of value added tax (VAT) (not a tax currently used in the U.S.) and the risks associated with it when Tax relies on manual processes and fragmented data. Engage them in thinking about issues with provision calculations and the composition of the taxes paid offshore.

Once you've aligned Finance and IT with your tax transformation project, the next step is to build a cross-departmental team with representatives from both departments who are responsible to and reporting into the Tax department. This is an essential element to the success of a tax transformation project. For example, having someone from IT as part of the team can help prevent tax transformation projects from going off schedule.

Regarding experience level, it's important to identify fairly senior people who can drive change within the organization, both within Tax and beyond. These people need to be able to develop the business case, run things day to day, and oversee the cross-departmental transformation team. They don't need to be an expert in tax transformation, but they do need to have a good amount of history from within the company and the respect of their peers.

Regarding time commitment, experience has shown that part-time resources only get you partial success. So create a focused project team from within the tax department and around the company, then bring in the right kind of part-time subject matter experts or other resources as needed.

Resilient, successful tax transformation requires lots of collaboration, committed stakeholders, a clear vision, tenacity, and leadership. You need to think big – and stay flexible and focused until you achieve your vision.

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Q. What are some best practices?

A. As you engage in the transformation process, consider the following best practices:

1. Think Big. Tax transformation needs to encompass other departments. So think bigger than just the people who are currently in your Tax department. Reach out to the "other contributors to Tax" – the people who sit in Business and Finance and even Shared Services functions. Each supports Tax in either a formal or informal way, making them a part of how you ultimately comply with your tax obligations.

2. Consider the new roles and skills needed. As you envision your future state, focus on the skills that people are going to need and where to effectively source those skills. People in your Tax department will need to participate and support new processes using new technology. They will have to change accordingly and learn how to do new things. You can also source skill sets from elsewhere in the organization – for example, further upstream in the business in Finance or a Shared Services organization.

3. Understand that transformation requires more than technology. Transformation is not just about technology, it requires process change. Ultimately, employees who are interacting with transformed Tax processes will need to make changes in their roles and how they perform work. For example, as you streamline and make processes more efficient, you may need to reallocate some roles to higher value types of activities, such as planning and dealing with audits. One of the key aspects of successful transformations is communicating where you're going as a Tax department; understanding how tax transformation will impact your people, departmental roles, and skill requirements; and planning for new training requirements.

4. Integrate tax processes. Returns, provisions, and audits are all handled via interrelated processes. But in most cases, these processes are not effectively connected with each other. Tax transformation is about making sure that these tax processes are married with, or even embedded into, the upstream accounting and business process and related systems. The goal is to have an integrated, event-driven process that includes Tax. It's not easy to get there, but ultimately, doing so yields significant benefits in terms of downstream automation (for greater efficiency and fewer errors) and being more forward-looking (for better tax planning).

5. Invest in data management first. When it comes to tax software, the old adage holds true: garbage in, garbage out. So if your tax data is full of errors, then your provision, compliance, and other activities will be riddled with them as well. That's why it's best to invest in new technology that will solve tax data management problems first.

Solving tax data issues isn't easy. It requires looking upstream to where the vast majority of tax information is created. In most cases, the Tax department isn't the originator of data or transactions; it's just the consumer of data. To figure out how to improve data management, you first need to ask questions such as:

- Is data electronically available? Can it be accessed easily by tax professionals?
- Is the format and level of detail (including tax attributes) provided by data providers appropriate for easy consumption by Tax?
- Does data tie out to consolidated financial statements?
- Where are manual interventions needed to collect or input data? Can they be automated to eliminate potential errors?

Ideally, as data management processes are transformed, Tax will receive information – complete with tax attributes – from upstream systems closest to where the recording of transactions is actually happening. Keep in mind, this may require that Tax get involved in IT and Finance transformation projects.

For example, when Finance is preparing to upgrade or replace its ERP system for finance, Tax should:

- Influence Finance to choose a consolidation application that can support different hierarchies for Tax.
- Request that new financial statements include consolidated trial balances for all legal entities worldwide – not just business unit-level entities.
- Communicate the need for accurate accounting of revenues and costs by product, by legal entity, and on an actual and forecast basis to enable proper handling of transfer pricing from a tax perspective.
- Ask for detailed account structures needed to determine required book-to-tax adjustments.
- Request the use of multiple ledgers to accurately manage the company's non-U.S. tax obligations, if appropriate.

Historically tax departments have struggled to get involved in these types of projects early enough to have their requests heard and implemented. The best approach is to be assertive, as the rewards of solving tax data problems are significant and can greatly accelerate tax transformation. Benefits include:

- Accurate legal entity accounting
- Multiple ledgers for non-U.S. entities – for example, local statutory accounting, U.S. GAAP, and more
- Additional detail within the chart of accounts
- Tax-sensitized forecasts

"The key is to understand that tax transformation is not just about technology or process change," says Robert Guarnieri of Ernst & Young. "Ultimately, the people interacting with all parts of Tax need to be willing and able to help drive change."

> "You need both vision and tenacity. You need to have a vision and think big, and be bold! You need the tenacity to keep pushing and be creative in finding a way to achieve your vision for tax transformation."
>
> - Albert Lee, Ernst & Young

Q. How do you build a roadmap?

A. A tax transformation roadmap describes what your tax department will look like during and after the transformation process. Describe in detail the end result for both your department and organization.

As you build a roadmap, recognize that you can't take on everything at once. Even some of the most adaptable organizations need to prioritize and focus on certain areas first – usually around the primary pain points, areas of significant risk, or changes viewed as delivering the quickest benefit. Equally important, consider some of the other changes going on in your organization over the next five years. For example, if you know that your ERP application will be upgraded in three years, it may be wise to keep tax process changes simple during this period and focus on being a part of that project. These are examples of things you want to account for and build into your roadmap so you can avoid rework in the future.

It's also essential that your roadmap have clearly defined milestones that help you continue the momentum. Change is hard for most people – so in order to continue the momentum it's wise to celebrate the accomplishment of meeting each milestone, recognizing that even though change was hard, it was worth it. The process can get everyone charged up and ready to take on the next hurdle. It also helps you continue to secure funding from upper management as you move ahead.

Equally important, develop a *flexible* roadmap. You may need to change your plan – for example, by changing the staging or timing of milestones, to overcome a new barrier or take advantage of a new opportunity. For example, if Finance suddenly announces that they're implementing a new general ledger and building out a financial data warehouse, you'll want to change your plan to take advantage of the capabilities this type of change enables. Once you have a roadmap and a budget, prioritize what's achievable with the available budget.

Ernst & Young's Albert Lee also explains that it's best to ensure the roadmap and business case is tax-specific. "Typically, the Tax department has gone to Finance and asked for their transformation agenda and then tried to make a business case in the same way Finance had. This can have unforeseen and unwanted consequences because the roadmap is not tax-specific. To make a transformation based on standard Finance metrics is not the way to go, and companies need to think about the components that impact Tax and the value that Tax is driving."

Learn From Your Peers

Getting assistance is crucial to tax transformation projects - from others inside your organization, inside your peer group within your industry, or even reaching out to a service provider. Someone who's been through this process before can give you tips, guidance, and thoughts on how to stay away from the pitfalls; and that's not only in building the business case, but also in building a roadmap as to where you want to head. But also recognize that as you get that advice, it's going to be tailored to each organization. If you talk to your peers in other industries, recognize that every company is different. The insight of others is important, but fit that within the facts of your culture and your organization.

Learn more

This webcast and article discussed some of the approaches, processes, best practices, and technologies associated with tax transformation. For a deeper discussion of the role of data management in tax transformation, Vertex will host the 2012 "Future of Tax Operations" webcast series including a discussion of the challenges, technology options, and best practices for developing a tax data management solution.

For more information visit www.vertexinc.com/enterprise.

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