

The Tax Aspects of Finance Transformation

BY BOB NORTON

As companies shift from the recession's defensive postures to pursuing increased market share and revenue, chief financial officers are focusing on transforming finance operations to support growth in an efficient and managed way. For finance this means transforming processes to enable sound risk management and compliance with global hyper-regulation as their companies continue to expand.

Central to transforming finance is standardizing both transactional and business advisory services across geographies and lines of business. This includes everything from planning, budgeting and forecasting to the monthly close and more. It also includes the tax process life cycle of planning, provision, compliance and defense. While tax transformation is an integral part of finance transformation, it is often saved for last and in some cases never addressed.

However, by embracing tax as part of finance transformation, strategic CFOs can increase cash flow and earnings per share, while improving the internal controls associated with the financial reporting of income taxes. A desirable by-product of this approach is much improved efficiency around the tax workflow of both finance and tax resources. To realize the significant returns from a strategic approach to tax, finance must play an essential role to ensure that tax is part of overall finance transformation.

Making tax an early and integral part of financial transformation can yield significant cash, tax and earnings benefits, as well as improving internal controls associated with the financial reporting of income taxes.

Tax Transformation = Value Creation, Decreased Risk

When looking at process transformation on the finance side, CFOs will often ask questions that relate to two overarching themes: do the changes we're making create value and reduce risk? In the tax context the questions would be:

- Do you know the status of your company's global outstanding tax obligations?
- Are they being minimized?
- Are they controlled and monitored to ensure tax compliance as well as accurate financial reporting?

All too often when it comes to tax, CFOs either leave these questions unanswered or assume the answers are "yes." The reality is that the answers are not that simple and given the potential risks, CFOs would be well served to delve a little deeper.

What they will likely find is that tax transformation is needed, should be an ongoing process and — if approached as a collaborative effort between the two departments — will not only increase value (improved cash flow and EPS), but also yield benefits in the form of better tax governance and reduced risk.

Consider the tax and risk profile of a \$5 billion multinational with 50 U.S. legal entities operating in all states and 300 non-U.S. legal entities operating in 30 countries.

With four years open to tax audits, this company could have 10,000 tax return obligations to control and account for in its financial statements. And that's just income tax liabilities.

Transaction tax obligations (sales, use, value-added tax, etc.) dwarf those numbers as there are thousands of jurisdictions and monthly filings. Between income and indirect taxes, total outstanding tax obligations could easily approach 50,000 open tax returns covering a four-year period.

Granted, not all are material. But even if only 10 percent are eventually audited, that is 5,000 tax issues to manage and account for in the financial statements. From a tax accounting standpoint, there are many traps for the un-

wary — for example, the deferred tax impact of tax rate and law changes or the calculation of domestic and foreign subsidiary outside basis differences to support the company's APB 23 (ASC 740-30-25) indefinite reversal assertions.

Add to these FIN 48 and FAS 5 reserves for each tax obligation and it is apparent why audit committees are concerned with the company's overall tax accounting and risk management practices.

In fact, the regulatory oversight of tax accounting has never been greater. With the current environment of tax hyper-regulation and increased focus on transfer pricing, the scrutiny of tax accounting is unlikely to decrease anytime soon.

Consider these developments. According to the Public Company Accounting Oversight Board, "inspectors sometimes observed deficiencies in (audit) firms' procedures to test the valuation of deferred tax assets and tax contingency reserves."

More recently, the U.S. Securities and Exchange Commission has increased scrutiny of FAS 5 (ASC 450) contingencies and disclosures related to non-income taxes. In one case, the SEC took action against a company that failed, "to maintain appropriate internal controls and books and records relating to its sales tax liabilities," states SEC Release 63688 of Jan. 10, 2011.

As a result, it is likely that external auditor scrutiny will increase in these areas. When that happens, the audit committee is not far behind. If tax is left out of larger transformation efforts, CFOs could find themselves managing surprises, instead of managing global tax risk proactively.

The Role of Finance

Assuming tax transformation is worthwhile in the pursuit of value creation and risk reduction, what is finance's role in transforming the company's global tax operations and how is it accomplished?



Tear Down that Wall. The first and most important step for finance professionals is to gain a deeper understanding of the tax process and life cycle, the related controls and impact on value creation. To do this effectively requires willing collaboration by both the finance and tax departments.

For most companies the finance life cycle starts with a multi-year strategic plan that informs the annual budget, followed by monthly closes of actual results as well as forecasts. These processes and the underlying information technology infrastructure and systems support external SEC reporting as well as management reporting, both of which are typically accounted for on a U.S. generally accepted accounting principles (or possibly International Financial Reporting Standards) basis.

Operations are tracked and reported based on business units, which may be product or geographically-oriented, depending on how the company manages its business.

The underlying data and financial statements are typically maintained for three years to satisfy SEC reporting. While management reports may detail results by product or business unit by natural account class, SEC reporting is at a much higher account summary level. For the \$5 billion multinational operating in 30 countries, it is a lot of data to consolidate, translate and report, requiring significant accounting expertise, enterprise information technology systems and headcount worldwide.

Contrast this with tax operations. The tax life cycle starts with tax planning, which likely begins with finance's budgeted worldwide U.S. GAAP results. This results in a budgeted effective tax rate based on budgeted transfer prices, followed by the implementation of tax plans to support the intended legal entity profit targets and resultant effective tax rate.

At each monthly close, tax watches revenue and expense variances to budget



and the impact on transfer prices and the effective tax rate. At quarter end, tax relies heavily on finance's forecasts in determining the company's "estimated annualized effective tax rate," to be applied to year-to-date pre-tax income in accordance with FIN 18 (ASC 740-270).

Then at year-end, after finance has determined pre-tax income, tax calculates the annual tax provision, final effective tax rate, deferred taxes and uncertain tax benefit disclosures. In the following year, the tax returns would be filed and over the next three to 15-plus years the audit defense process would unfold.

In comparing the data needs between finance and tax, the quantity, format and detail of data as well as the time spans are likely to be significantly greater for a company's tax operations versus its finance operations, and in many cases are not being addressed by the current infrastructure and processes for SEC and management reporting.



It's all About the Data.

Finance should understand the foundational systems and data needed to optimize the tax process as well as enable realization of tax value. Though the tax and finance life cycles are different, they do share a common need — global financial data. Accurate financial data, and the speed at which it is delivered,

is the core of both departments' ability to create value and manage risk.

For finance, leveraging the strategic value of data and ensuring it provides insight beyond the numbers is essential to effective transformation and the company's ability to compete. Converting data to information to enable insight is clearly the same for the tax function, except that they are largely dependent on finance to get the data needed in a timely, efficient fashion — and finance already has its hands full with SEC and management reporting.

Based on experience with almost a

dozen large multinational tax accounting transformation projects, there are some common voids in foundational accounting and system infrastructure that if addressed would eliminate manual, spreadsheet-based tax workarounds and the related control weaknesses.

These include:

1. Accurate legal entity accounting;
2. Multiple ledgers for non-U.S. entities — for example, local statutory accounting, U.S. GAAP, statutory accounting basis to GAAP (or stat to GAAP);
3. Additional detail within the chart of accounts; and
4. Tax-sensitized forecasts.

In terms of entity structures, instead of business unit-level financial statements, tax needs them by legal entity. In the example above, for a given year, it would need to see consolidating worldwide trial balances for 350 legal entities. That is how taxes are assessed in every jurisdiction in the world. There is simply no getting around it. So, if finance does not produce the statements, tax will and that could be an internal control weakness.

Then, to support the company's transfer pricing and legal entity profit targets, tax needs accurate accounting of revenues and costs by product, by legal entity on a budget as well as actual and forecast basis.

In addition, accurate intercompany balances and transactions must be tracked and monitored between affiliated counterparties. Without this, the budgeted effective rate could vary significantly from actual due to variances in targeted profit levels and that is never a desirable outcome.

When it comes to account structures, tax typically needs more detailed accounts to determine required book-to-tax adjustments. For example, meals need to be separated from travel and entertainment (T&E) and certain types of entertainment need to be tracked due to their non-deductibility in various jurisdictions.

Then there's the issue of multiple ledgers. In addition to trial balances by

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legal entity, tax needs multiple ledgers to accurately manage the company's non-U.S. tax obligations. A U.S. GAAP ledger is fine in the U.S. But outside the U.S., in addition to a U.S. GAAP ledger, tax needs a local statutory accounting ledger as well as a stat to GAAP adjustments ledger. This is because most countries impose income tax on a local statutory accounting basis (some with further stat to tax adjustments to arrive at taxable income). That is how the provision is computed and how the return is filed.

And, it is the only way that accurate non-U.S. "return to provision" true-ups can be computed, which is a troublesome area for multinationals and a growing ASC 250 accounting concern regarding error versus change in estimate.



It's About Process, Too. In accordance with Transformation Theory 101, it will be necessary to assess the company's current tax process including planning, provision, compliance and defense, as well as how transfer pricing is determined, monitored and defended over the tax life cycle. Once concluded, then define the desired state. The gap between the two is the company's roadmap.

As part of the reviews, particular attention should be paid to data: the sources, flows, access and touches. Is it electronically available? Is it accessible by site controllers and tax resources? Is its format and level of detail sufficient to support the tax lifecycle? Does it tie out to the consolidated financial statements?

After that, determine where and how often there are human interventions of manual inputs and calculations (e.g. Sec. 199 deductions). Why are these required and how can they be automated or at least partly automated?

Is the underlying provision data leveraged to the estimated tax payment and tax return filing process? If not, why not and how can it be? Is provision and compliance data leveraged to the subsequent tax planning process? This will clearly yield benefits in managing the company's trans-

fer pricing process, which is typically the main driver of the effective tax rate and cash taxes and also likely the most material tax exposure to the company.

Investing in Tax Transformation

Skilled tax professionals, with support of the CFO and business managers, can find savings throughout the business, whether it be via tax-efficient mergers and acquisition structuring, optimizing transfer pricing or just maximizing timing of deductions to generate cash flow. When one considers that in some jurisdictions up to half of a company's profits are consumed by taxes, significant value can be created from tax optimization.

However, it is highly likely that the tax function cannot generate this kind of value without the support of the finance team. By embracing tax transformation as a willing sponsor and including it as part of overall finance transformation, finance can create shareholder value while reducing financial reporting risk which, if done well, could even pay for itself. ☛

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Recommended CPE Credits: 1.0

Experience Level: Basic

Field of Study: Tax

Prerequisites/advance preparation: None

Advanced Prep: Reading article



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