Internal Controls Environment: A Tax Perspective

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Agenda

- Setting The Stage
- Current Tax Environment
- Tax Process / Risk Areas
- Examples
As Corporations continue to evolve and expand into the ever changing global economy, they must continually update and transform their accounting and tax reporting environment to adjust to the changes.

Unfortunately, while the accounting and tax compliance / financial reporting requirements are running at warp speed to keep pace, the internal controls environment in many organizations has lagged and is struggling to catch-up.

The result is an organization with an alarming risk profile in one of the areas which presents a significant organizational risk, internally and externally.
In the News…

The number of audit deficiencies continues to grow -

_The PCAOB’s 2011 inspection reports will show an increase in audits found to have serious problems which includes a number of cases where “audit work wasn’t completely or properly conducted, or the company’s financial statements were contradicted by other evidence.”_

“In the reports issued last year, the board found deficiencies in nearly a third of audits examined at Big Four accounting firms.”

Current Environment

Today’s Internal Audit environment has changed dramatically from 2002:

- Shift in focus from reporting and compliance requirements to strategic, operational and financial maturation of an organization’s processes
- Reliance on Internal Audit to identify linkages between departments and mitigate the related exposures
- Leveraging subject matter experts to gain in-depth knowledge of the various process areas
- Expectation of collaboration between Internal Audit and the various departments to further enhance process and control best practices
- Leveraging internal audit work to gain external audit reliance
Tax is the Leading Source of Material Weaknesses

- Tax: 24%
- Revenue Recognition: 22%
- Inventory: 17%
- Fixed and Intangible Assets: 14%
- Other: 23%

2011 Study by Deloitte on the number of material weaknesses related to US GAAP between 2008-2010
Tax is the Leading Source of Material Weaknesses

A review of financial statement disclosures reveals that the top 5 causes of tax material weaknesses\(^1\) are attributed to:

- Insufficient review by management (23%)
- Personnel (lack of training, resource constrained) (22%)
- Lack of general procedures or process (13%)
- Inadequate reconciliation (10%)
- Improper treatment/recording (10%)

Note > All of these areas should be addressed in companies’ Controls Environment.

\(^1\)2011 Study by Deloitte on the number of material weaknesses related to US GAAP between 2008-2010
Internal Audit and Tax

In meetings with several Internal Audit Executives over the past several months, we have learned the following:

- Internal Audit Departments typically rely on support outside of their function when it comes to Tax.
- Dedicated Internal Audit service providers many times need to partner with others to provide technical expertise with respect to Tax.
- Tax Departments typically rely on original SOX documentation from 2004/2005.
- Transactions many times create gaps in the internal control environment.
- SOX documentation and controls remain static while the organizations have changed (reorganizations, staffing, roles and responsibilities).
Tax Department Environment

Tax departments are facing a number of challenges:

- Shorter financial close cycles
- Shortages of tax talent
- Increased transparency in financial/tax reporting
- Pressure to link value drivers with enablers
- Increased regulatory requirements
- Managing cost of functions
- Competing goals with Finance
  - Timing
  - Talent
  - Communication Chain
- Lower risk tolerance *(Internal / External)*
Tax Department Environment

- Accounting/Finance Pressure to Close
- Indirect Tax Compliance
- Tax

Timeline to Close

Year End

Financial Statements Due
Tax Internal Control Environment

Macro Level

Financial Reporting

Tax Financial Reporting (Provisioning)

Tax Compliance

△ = key control
Internal Audit’s role has been extending to not only include proper control procedures, but also to be a key driver in maturing the tax processes and operations.
# Tax Maturity Model

<table>
<thead>
<tr>
<th>Initial</th>
<th>Repeatable</th>
<th>Defined</th>
<th>Managed</th>
<th>Optimized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limited or outsourced tax department</td>
<td>Adequate internal tax department staffing of critical functions within Tax</td>
<td>Team efficiency maximized by leveraging knowledge and resources at the appropriate levels</td>
<td>Regularly evaluates the need to reorganize Tax Department to leverage / optimize strengths of team members</td>
<td>Tax Department organizational structure is globally aligned with corporate strategy and management</td>
</tr>
<tr>
<td>Resources and knowledge limited to select individuals</td>
<td>Leveraged tax department personnel and knowledge sharing</td>
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<td>Strategic use of external resources</td>
<td>Strategic use of external resources</td>
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<tr>
<td>Limited in skill sets and industry knowledge</td>
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<tr>
<td>Undocumented and undefined policies and processes</td>
<td>Documented policies, procedures and controls</td>
<td>Clearly defined roles and responsibilities in accordance with the existing tax department structure and within the appropriate process flows</td>
<td>Continual strengthening of existing controls and processes, to address any organizational / business changes</td>
<td>Use of automated solutions, which may be leveraged across multiple process areas, such as compliance, financial reporting, mgmt reporting, etc.</td>
</tr>
<tr>
<td>Ad hoc process and minimum controls</td>
<td>Review policies, procedures and controls and controls on an annual basis and updated accordingly for changes</td>
<td></td>
<td>Create detailed process manuals and desktop procedures</td>
<td>Existing processes have the ability to tolerate changes to the company structure</td>
</tr>
<tr>
<td>Spreadsheet dependant</td>
<td>Use of standard templates and Excel spreadsheets</td>
<td>Standardized workpapers designed across all tax processes (ex. integration of tax compliance and tax provisioning)</td>
<td>Implemented effective system and spreadsheet control procedures</td>
<td>Implement automated solutions to build in efficiency mitigate risk, and serve multiple strategic goals</td>
</tr>
<tr>
<td>Minimal internal use of available technology solutions</td>
<td>Spreadsheet maintenance performed annually and update accordingly, in coordination with company policy and procedures</td>
<td></td>
<td>Use of appropriate technology tools, where applicable</td>
<td>Use of a department intranet, SharePoint solution, etc.</td>
</tr>
<tr>
<td>Not strategically aligned within organization</td>
<td>Not strategically aligned within organization</td>
<td>Tax plays a role in execution of strategic initiatives and decisions</td>
<td>Tax plays a role and is actively involved in strategic organizational decisions</td>
<td>Strategic alignment of Tax / Accounting / Finance</td>
</tr>
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<td>Tax is proactive in implementing solutions to adapt to the changing environment</td>
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Tax Process Areas

- Income Tax (Provisioning & Compliance)
- Property Tax
- Value Added Tax (VAT)
- Transaction Taxes
- Unclaimed Property
- Transfer Pricing
- Legal Entity Rationalization / Structuring
- Tax IT / Security
- User Defined Applications
- Segregation of Duties
- Payroll Tax
Income Tax Processes

Tax Financial Reporting (Provisioning)

- Annual/Quarterly Processes
- Effective Tax Rate (ETR)
- Return to Provision
- Tax Basis Balance Sheet
- ASC 740-10 (FIN 48)
- Account Reconciliation
- Journal Entries

Income Tax Compliance

- Data Collection
- Tax Return Preparation
- Audit Management
- Notice Management
- Account Reconciliation
- Journal Entries
Tax and Other Processes

Indirect Tax (Sales and Use, Property, VAT) and Unclaimed Property

- Data Collection
- Tax Return Preparation
- Audit Management
- Notice Management
- Account Reconciliation
- Journal Entries

Transfer Pricing

- Allocation Methodologies
- Transfer Pricing Analysis/Review
- Maintenance of Contemporaneous Documentation
- Account Reconciliation
- Journal Entries
Internal Control Review Triggers

Signs you need to review your internal controls:

- **External**
  - Implementing a new ERP system or other software
  - Acquisition, disposition or other organizational change
  - Rapid growth or expansion

- **Internal**
  - Changes in department personnel structure
    - New hires/promotions/turnover
    - Changes in department skill sets
  - You can’t remember the last time you reviewed them!
  - You can’t remember the last time *anyone* reviewed them!
Sample Services Provided

- IPO Readiness
- Transactional Transition Services
- Remediation Consulting - Material Weakness and Significant Deficiency
- Internal Control Environment Assessments
- Internal Controls Operational Effectiveness Review
- Internal Controls Testing
- Drafting and or updating of Internal Controls Documentation
  - Process Flows
  - Risk Control Matrix
  - Draft Test Plans
- Our buyers of these services are Directors of Internal Audit, VP’s of Internal audit, CFO’s and Strategic Partners.
Current Projects (Hotel Chain)

- Hotel Chain (Sub-Contractor to Protiviti)
  - Process Design (Control Procedures and Process Flow)
  - Remediation of Tax Material Weakness, effectively
  - Design of Internal Audit Test Procedures
  - Internal Audit Testing – Quarterly / Annual (2011)
  - Modification of Internal Audit Test Procedures (2012)
  - Internal Audit Testing – Quarterly / Annual (2012)

- Development and Communication of Internal Audit Recommendations and Observations report to Management Team
  - Currently working with the Tax Team to implement our Recommendations.
Current Projects
(Home and Security Products)

- Home and Security Products
  - Tax Process Design (Control Procedures and Process Flow)
  - Re-Implementation of SOX, due to Spin off
  - Integration of Tax Provision and Tax Compliance (OneSource)
  - Member of the Internal Controls Management Team
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Questions ?