

Tax accounting processes
Time to go back to basics?



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Tax issues continue to be a major cause of material weaknesses and restatements. As a result, many companies are taking a “back-to-basics” approach to improve the tax provision process and related internal controls. Companies are changing resource models, obtaining training, integrating processes, and turning to automation in response to the additional requirements facing tax departments.

Deloitte hosted a Dbriefs webcast on September 22, 2008, to review the most common causes of tax material weaknesses and to discuss steps organizations are taking to address them. More than 4,300 participants tuned in to learn about leading practices for improving the tax provision process through the management of people, processes, and technology, as well as to share their own views through responses to polling questions.

Tax issues and material weaknesses: Where do we stand?

Four years after Sarbanes-Oxley intensified the focus on internal controls, companies continue to report a significant number of tax-related material weaknesses. From October 2006 through October 2007, 108 companies reported material weaknesses due to tax issues with many of those reporting multiple deficiencies. Of the more than 165 deficiencies identified with these material weaknesses, more than half were related to either:

- Overall lack of resources or lack of resources with sufficient tax accounting expertise, or
- Insufficient reviews (or lack of any review) of the tax provision.

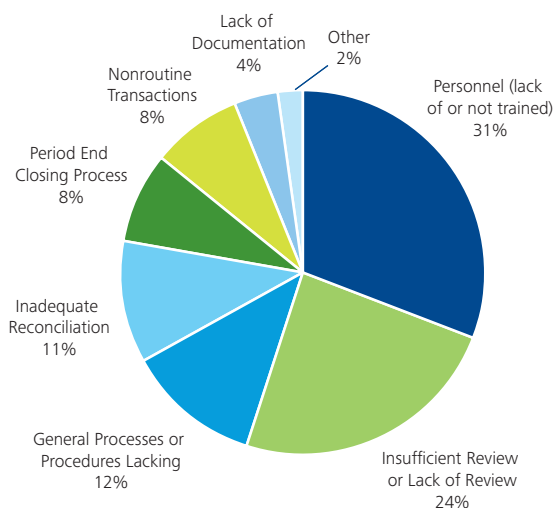
What is causing the issues today?

One contributing factor is the structure of tax departments. Specifically, many tax departments “built” for the 1990s—i.e., with a primary focus on tax compliance and

planning—are finding themselves unequipped to handle the new and additional issues of today:

- The accuracy and timeliness of the interim and year-end tax provision are as important as tax compliance.
- The compliance-based processes do not support tax provision requirements.
- Spreadsheets used to collect and retain information for both tax compliance and provision processes remain separate and not well integrated.
- Tax departments lack sufficient education and experience in tax accounting, including tax technical issues and how those relate to accounting principles generally accepted in the United States of America (U.S. GAAP).

Leading causes of tax material weaknesses



At the same time, scrutiny of taxes has increased, requiring companies to provide more comprehensive support for ending balances, adjust to a lowering tolerance for true-ups, and better define and document internal controls. While FAS 109 dramatically changed tax accounting from

an income statement to a balance sheet approach, many tax departments did not adjust their internal processes. Many processes retained an income statement approach, using spreadsheets or similar “add-ons” to achieve a balance sheet presentation. This lack of a balance sheet approach focused on ending balances often leads to issues that result in significant deficiencies. Companies are finding there are a variety of issues that can lead to problems, for example:

- Evaluating the tax accounting consequences of a transaction after the transaction closes (and often after the end of the quarter or year-end).
- Relying on estimates that are not updated to reflect recent business changes.
- Recording the change in deferred taxes without maintaining or evaluating the underlying book/tax basis differences.
- Evaluating the change in the current payable or receivable accounts as opposed to “proving” what the ending balance represents.
- Determining the impact on tax accounts when an examination by a tax authority closes.

In short, there are many factors that can affect a company’s tax provision processes—business combinations, legal entity structures, level of automation, degree of centralization or decentralization in the organization, and even the roles and responsibilities of people across departments. As a result, a “one-size-fits-all” approach just doesn’t work. Companies must assess their unique tax provision needs and plan improvements accordingly. For many, this means going back to basics.

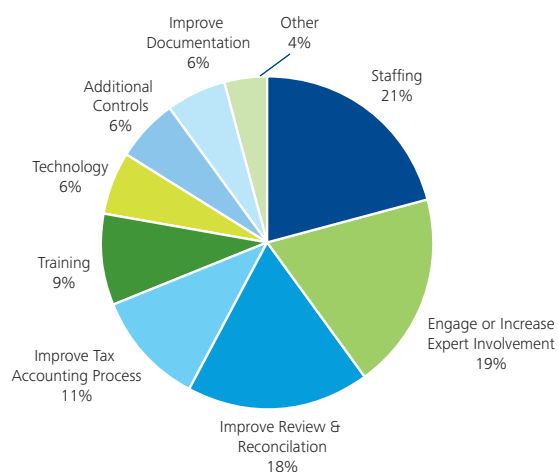
What steps are companies taking to address these problems?

Companies that disclosed tax-related material weaknesses reported a variety of remediation efforts, as illustrated in the exhibit. Not surprisingly, nearly 50 percent of these actions relate to people:

- Increasing staffing internally.
- Bringing in more outside experts.

- Enhancing training, not just in technical areas but also in review processes, including reconciliations and proving ending balances.

Remediation efforts



In addition to addressing the resource issues, tax directors are taking a variety of steps in areas related to processes, internal controls, and automation.

Resource strategies

Given the shortage of FAS 109 resources available in the market today, companies are trying a variety of strategies to ensure they have the knowledge and capacity to address tax provisions. Such strategies include new tax accounting roles, loaned staff, redeployment of existing resources, and sometimes outsourcing the tax provision or compliance.

Some larger companies are introducing new tax leadership roles. One such role is a *director of tax accounting/reporting*, typically with accountability for SEC reporting, global data collection, final approval of disclosure issues pertaining to the tax provision, and coordination of resources—depending on whether the controller/finance or tax organization retains overall responsibility for the tax provision. Another evolving role is a *director of tax*

technology. Most companies still rely on dedicated or shared resources in the Information Technology department to help with tax technology needs. But, as technology continues to improve the tax provision and return processes—with new tax provision software replacing spreadsheets, better linkage with general ledger and compliance systems, and more sophisticated data collection software—the need for dedicated tax technology resources increases. This role is responsible for not only infrastructure and vendor management, but also for the deployment of technologies across the tax function, including data collection, tax portals, tax provision software, and specialty tax adjustments (LIFO, depreciation, Section 199, etc.).

Regional controllers and/or centers of excellence are not new concepts for many companies, but these roles take on greater importance as countries and companies convert to International Financial Reporting Standards (IFRSs). As statutory accounting further aligns with, and is ultimately replaced by, IFRSs, there may be a greater interest in consolidating tax reporting. Depending on the size and scope of the company, the material tax jurisdictions may become “regionalized.” For U.S.-based multinational companies, some are establishing internal tax managers or directors for major countries as opposed to relying on a regional or country controller who often has many accounting responsibilities. This is a common solution for remediating a material weakness related to lack of visibility or control over tax information for material tax jurisdictions.

Tax provision process strategies

Given the increased scrutiny of taxes, tax departments have had to focus on both interim and year-end processes. Companies have developed processes that accelerate the review of tax accounting issues and, therefore, reduce the amount of work being performed at year-end. This is important not only to alleviate resource constraints but to avoid surprises impacting financial statements.

In evaluating *interim processes*, many companies found they were completing a full tax provision process every

quarter and that they could substantially reduce quarterly work by:

- Replacing a full quarterly tax provision process with one that forecasts the effective tax rate (ETR) for the year and appropriately accounts for discrete items in the period they occur.
- Leveraging the process for determining cash estimated payments.

By leveraging work done in other areas (for example, cash payments) and by concluding on discrete items earlier, departments can focus on the more significant issues, especially those involving estimates and judgments. Potential issues can be discussed earlier with internal management and external auditors to reduce potential year-end surprises, significant deficiencies, and material weaknesses or restatements.

With respect to *year-end processes*, companies are using technology to improve data collection and build automated computations into year-end processes to save time and reduce errors. They are devoting greater attention to developing and documenting estimates — steps that can be critical when a return-to-accrual adjustment is evaluated to determine whether it is a change in estimate or an error. While information needed to file tax returns may not be available during year-end close, companies may be able to reduce those return-to-accrual adjustments by focusing on material book/tax differences and related estimates and judgments, especially those subject to volatility. When it comes to state computations, companies are focusing on:

- Legal-entity computations for the most material entities.
- State basis versus book basis where there are state-specific differences.
- Tax rate changes and other changes in their businesses that could affect the total state tax provision computation.

While tax departments documented their tax processes to initially comply with Sarbanes-Oxley (SOX), that documentation may not have been updated to

reflect processes that have evolved or where process improvements were made. Or the controls were based on an inefficient process to begin with, resulting in the need for change. As a result, every process improvement effort involves a documentation component. While tax departments typically have SOX documentation, it may not be sufficient to meet corporate tax executives' needs. Some companies have begun to use tax provision workflow management software or a tax provision preparation guide—a detailed document that compiles and organizes disparate data according to preferred processes. Such a tool will typically include:

- Roles and responsibilities.
- Documentation of the entire process (flow charts).
- Narratives of tax internal controls.
- Procedures related to topside, consolidated, and “late” adjustments.
- Timeline/calendar.
- Checklists.
- Procedures to validate tax accounts and cumulative temporary differences.
- FIN 48 processes and automation considerations.

In addition, companies that use a roll-forward approach to deferred taxes have begun to incorporate an additional validation step into their working papers, agreeing the ending balance back to the general ledger or ending balances from supporting working papers from other systems. Finally, many have procedures in place to properly document deviations—for example, by creating memos that address changes to the interim tax provision processes or document reasons for certain decisions.

Tax provision automation strategies

While “full” automation is attractive and becoming more possible due to significant software development, most companies are more incremental when defining their initial automation opportunities. Establishing a “destination”—what the integrated system may look like and the level of automation that will be added over the next 12 to 24 months—makes it easier to plan and manage the transition and limit the need for re-implementations later.

A key first step for many has been adopting tax provision software. In doing so, companies should look at a variety of factors to make sure a solution meets their specific needs:

- Cost of the license.
- Scope and cost of implementation—including the cost of implementation and the cost of data migration, two discrete elements.
- Resources required for both implementation and ongoing use.
- Second-party or third-party support.
- Integration and/or alignment with other systems, including tax planning, general ledger, data collection software, database query tools, and workflow tools.

To maximize the benefits of tax provision software, many companies are finding it useful to:

- Establish an internal champion to oversee changes, maintain focus on project goals and milestones, and rally support when needed.
- Keep the external audit team informed of technology changes and involved in decisions about controls modifications or other adjustments.
- Identify unique tax provision factors and maintain tight control around the “extra” steps required to address those.

The global move to IFRSs: Prepare for more changes ahead

The conversion to IFRSs presents a host of additional considerations. More than 100 countries currently use IFRSs, with some major jurisdictions, including the United States, expected to convert over the coming years. Furthermore, each country is migrating at a different pace and in a different manner. Convergence of local standards with IFRSs likely will require companies to change how they collect data and maintain legacy systems. Additionally, companies must prepare for a transition from FAS 109 to its IFRS counterpart, IAS 12. As companies establish tax provision software and update their internal processes today, they should make sure these changes also consider IFRS functionality and reporting capabilities needed down the road.

Tax executives' views

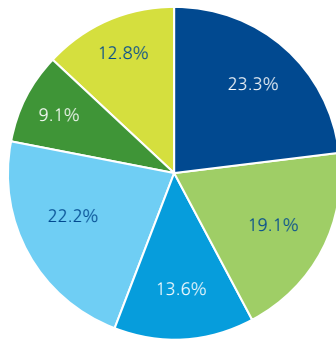
To address the most common causes of tax material weaknesses and the steps that organizations are taking to address them, Deloitte hosted a Dbriefs webcast entitled "FAS 109 and FIN 48 Processes: Time to Go Back to Basics?" on September 22, 2008. More than 4,300 participants joined the webcast, which featured a discussion on leading practices for improving the tax provision process through the management of people, processes, and technology.

Hiring qualified staff and accounting for the tax effects of nonroutine transactions pose the greatest challenges to tax accounting, according to participants' responses to one

of the polling questions. Performing timely reviews and reconciliations also creates significant challenges.

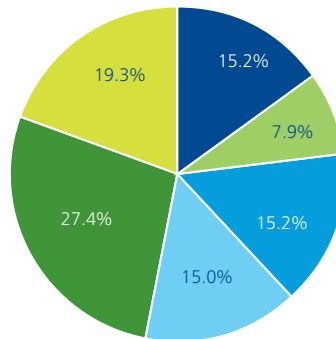
Looking forward, more than one-quarter of the respondents reported that redesigning current processes and implementing new workflow procedures, including aligning general ledgers with tax requirements, would be their first priority for improving efficiency and quality. Hiring more resources, providing more training, and implementing tax provision software ranked equally as the next priorities to enhance efficiency and quality.

What are you finding most challenging in your organization with respect to tax accounting?



- Hiring qualified staff
- Accounting for the tax effects of nonroutine transactions
- Performing timely reviews and reconciliations
- Maintaining spreadsheet models
- Creating/maintaining documentation
- Not applicable

What is your first priority for 2009 to improve your tax department efficiency and quality?



- Hiring more resources into the tax department
- Implement provision software
- Launching or expanding cosourcing or outsourcing initiatives for compliance or provision
- Redesigning current process and implementing new workflow procedures, including aligning ERP with tax
- Deploy more training
- Not applicable

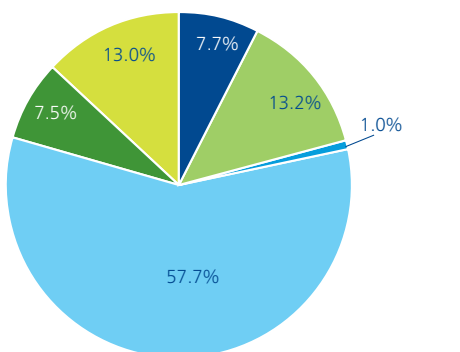
Regarding tax provision software, more than half of the respondents (57.7 percent) reported using Microsoft Excel® or Microsoft Access®. Another 13.2 percent indicated that they use Thomson Reuters products, while 7.7 percent reported using CORPTAX® products.

Not surprising, retrieving more accurate and complete data from ERP systems or accounting was cited by nearly one-quarter of the respondents as a way to improve the current tax accounting process. Approximately one-fifth

of respondents indicated that building processes and procedures to support a tax-basis balance sheet as well as training and reallocating resources would help improve their current tax accounting process.

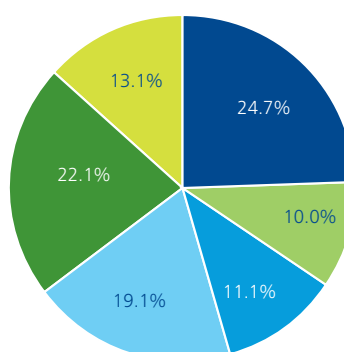
It is clear that improving the tax provision process requires a combined focus on, and investment in, people, processes, and technology. Now is a great time to start planning for those improvements.

What technology solution do you primarily utilize for your tax provision?



- CORPTAX® Provision or Advanced Global Provision
- Thomson Reuters products (TaxStream, InSource, CrossBorder)
- Longview Tax
- Microsoft Excel® or Access®
- Other
- Not applicable

How can you most improve your current tax accounting process?



- Retrieving more accurate and complete data from ERP systems or accounting
- Improving the foreign data collection process
- Eliminating spreadsheets
- Training and reallocation of resources within your department
- Building process and procedures to support a tax-basis balance sheet
- Not applicable

Additional resources

For additional updates on income tax accounting matters, please visit <http://www.deloitte.com/us/fas109>.

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