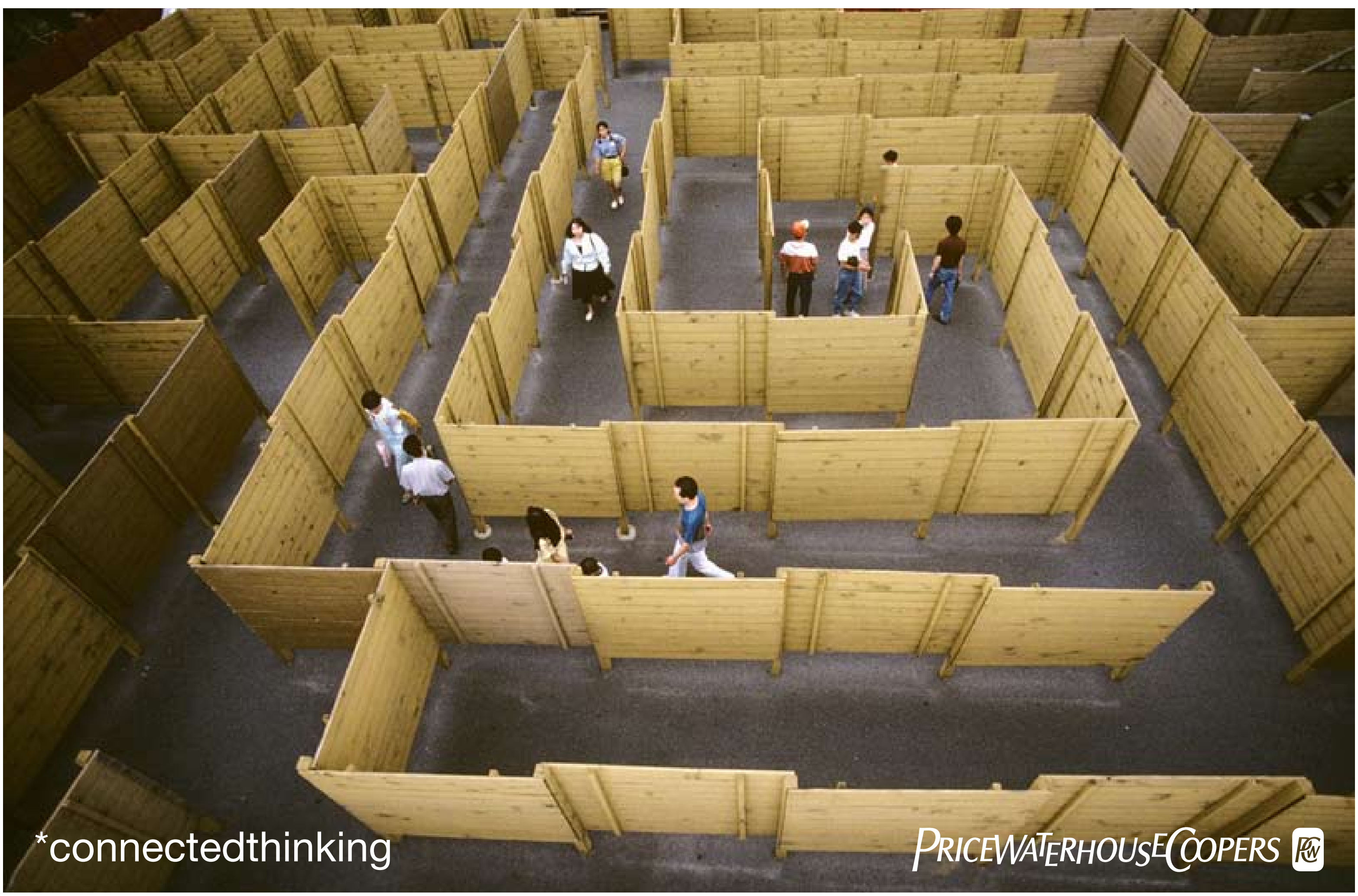
Managing the tax function through a weak economy*

An operations perspective



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The heart of the matter

The financial crisis and global recession have taken a significant toll on companies. Revenue and profits have fallen; companies have shed jobs in record numbers and curtailed spending and investment. Corporate tax functions are being asked to “do more with less” and “work smarter.” This implies a boost in productivity and efficiency and places new stress on processes, systems, and people executing business activities. Such stress may lead, in turn, to greater risk of volatility in the tax accounts and missed opportunities to reduce the effective or cash tax rate due to competing priorities and resource constraints.

Tax, like other enterprise-wide functions, faces close scrutiny during this time of business retrenchment. For years, the tax function has been under tremendous pressure to execute against an ever-increasing inflow of regulatory requirements while facing challenges associated with a decade or more of “low or no” investment in technology and process improvement. This increase in tax responsibilities, coupled with a prolonged “steady-state” approach to head count, has, in some cases, led to internal control deficiencies, financial restatements, and in extreme cases, a general loss of confidence in the tax function.

Given these competing challenges, how can senior executives effectively manage the tax function through a weak economy while waiting for conditions to restore corporate budgets?

Squeezing tax value from the budget dollar

When times are tough, companies rethink their businesses and recalibrate their resource and investment decisions. Though the short-term benefits of budget and head count cuts may seem attractive on paper, CFOs and tax VPs have a few options to consider when evaluating the tax function.

Option 1: ring fence

Human capital costs represent about 60 percent of the budget for a typical tax function, so it's not surprising that head count reduction is often the knee-jerk response for cost containment in a down economy. In a rush to reap the short-term benefits of a reduction in force, companies often do not consider the risks unique to specific functions. Perhaps more importantly, they may miss opportunities to realize untapped value by using those same resources differently through strategic process and technology investments.

The ring fence approach rests on the premise that head count reductions in tax should be avoided, and not simply expected, as part of a company-wide reduction in force. The rationale is that most tax functions are already dangerously understaffed and further reductions may lead to an increase in errors or an unnecessary increase in ETR or cash taxes. This is particularly relevant given that a company's tax function continues to be the single most frequently cited reason for material weaknesses in Sarbanes-Oxley internal control audits.[1]

This approach favors a long-term investment in sound risk and resource management over the short-term benefit of head count reduction. It is a strategic option for companies today—especially those with a history of material weaknesses, significant deficiencies, financial restatements, or amended returns.

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[1] Audit Analytics®

Option 2: give and get

If head count reductions are unavoidable, the tax function can opt to concede the inevitable, but in exchange, request a reasonable budget for technology enhancements to ultimately drive greater efficiencies. Since companies will not eliminate information technology budgets altogether, this could be an opportunity for the tax function to make a compelling case to shift budget from other functions/initiatives and get a larger allocation for tax projects.

By exchanging strategic head count reductions for additional technology investment, the tax function can make progress on the long-ignored technology agenda. This option not only supports effective risk management, but also enables the tax function to redeploy existing resources from data collection and validation to more value-added activities, such as data analysis and tax planning.

Of the 10 most commonly achieved benefits realized through greater use of effective technology, “freeing up staff” is probably most important in a weak economy. By using technology to reduce the hours required to complete tasks, companies can realize an efficiency dividend of 10 to 20 percent, which can be used to cover the potential reductions in head count.

Investments in new technologies may be a tough sell in the current environment. Alternatively, companies should be able to realize gains by making better use of their existing IT infrastructure that supports financial reporting, including enterprise resource planning (ERP) systems; business intelligence software; extract, transform, and load (ETL) tools; data warehousing systems; and even web portals. Enhancing the return on existing IT investments is often a very compelling proposition for CFOs.

Although the benefits of technology investments are clear, many companies—excited by the promise of what tax technology can do for them—too quickly experience implementation failures and budgetary resistance. We recommend taking a long-term view of your tax technology strategy and a “slow and steady” approach. Incremental progress not only spreads the budget, but also improves the probability that real change will take root.

Making the most of your technology spend

The efficiency dividend represents a return on a process improvement and technology investment in the form of more time available for higher, value-added activities.

Assume a tax function has 30 people on staff and delivers 60,000 hours of work. That's 2,000 hours per person.

What if the tax function did a few things like:

1. Link its general ledger with the tax accounting system
2. Automate computation of 20 book/tax accounting differences
3. Rely less on email and spreadsheets to collect tax data in favor of more sophisticated technology

What if those 3 things eliminated 6,000 hours of work so that our hypothetical tax function now only has 54,000 hours of work since the other 6,000 have been automated out of existence? What will most tax functions do with the extra 6,000 hours?

Do they…

1. Work less overtime with the hope of retaining people longer?
2. Transfer 3 people (2,000 hours x 3 = 6,000) to other parts of the finance function?
3. Terminate 3 people?
4. Redirect effort so more time is spent on:
    - Tax planning?
    - Managing audits and controversy?
    - Lobbying and tax policy?
    - Spending more time with the business units?
    - Dreaming up better ways to do the tax returns?
    - Further researching the validity of FIN48 tax reserves?
    - Working with non-US controllers to improve the data received in connection with tax accounting?
    - Etc., etc., …the list continues

In this example, the 6,000 hours is the <u>efficiency dividend</u>. It represents a return on the process improvement and technology investment in the form of more time available for higher value-added activities (item 4 above) or other possibilities like items 1-3.

Making the most of your technology spend

Historically, the tax function has tended to operate as a silo within the finance function. The result is that finance and IT leaders have become accustomed to either ignoring tax when looking at IT projects or bringing tax in so late in the systems development life cycle that it is no more than a token step in the project plan. Similarly, most companies have an expansive IT infrastructure that is not appropriately leveraged by the tax function. Best-in-class enterprises have dedicated one or more tax IT people to the tax function to support successful implementation, training, and maintenance of an effective tax IT environment.

Although adding head count within tax for an IT role may be nearly impossible in a weak economy, it is our experience that designating an IT specialist who, at least, partially supports the IT needs of the tax function can assist in creating the efficiency dividend. This efficiency could, in turn, result in eliminating unfilled and open tax positions or the need to replace those who choose to retire, vacancies created by normal attrition, or by those departing as part of a focused head count reduction program. The work of the tax IT specialists will contribute to an environment that relies heavily on automation—allowing for greater flexibility in managing head count.

Making the most of your technology spend

TIP... The art of compromise

In the “give and get” scenario, it’s important to negotiate and communicate effectively so that any resource concessions will be offset by the benefits of additional budget for technology improvements.

Prepare. Tax executives should evaluate and prioritize current/forecasted tax activities and associated resource needs—and, most importantly, realign the activities vis-à-vis any shifts in company strategy associated with the economic downturn—before engaging in discussions with company stakeholders. Then tax leadership should prioritize concessions and identify associated impact and activities “beyond compromise,” such as those that would impair risk management.

Know your stakeholders’ agenda, and communicate on their issues. The overall perception from many nontax people is that tax is a difficult, complex subject. Further complicating communication is the multitude of stakeholder groups who each have different interests and agendas. Therefore, it is essential to anticipate the requirements of each stakeholder group and design the appropriate method of communication with each to enjoy more success, acceptance, flexibility, and potentially, greater leverage in compromise.

In a down economy, regular communications between tax and the CFO (and likely the CEO as well) should increase so that company leadership is aware of and consulted on major tax issues. This will also ensure that the tax function is aware of what is happening more broadly in the business. Consistent, open communication with key stakeholders also creates a foundation for tax executives to garner support for investment required outside the tax budget or for enterprise-wide activities.

Initiate. After preparing, tax executives should initiate discussions with key stakeholders. This not only serves to elevate the tax function as a strategic partner, but also positions it as a proactive driver in a weak economy.

With the intersection between tax and financial reporting taking on renewed significance and the likely adoption of International Financial Reporting Standards (IFRS) in the next few years, CFOs are increasingly focused on getting tax right and should be receptive. C-suite discussions will enable tax to play a bigger role within the larger organization—identifying value opportunities and effectively communicating the broader impact those opportunities may have on the overall business.

Making the most of your technology spend

In a down economy, corporate budgets are limited and expectations for return on investment are high. It is important to evaluate—and prioritize—the optimal ways to make the most of your technology spend and how that spend translates to benefit for your stakeholders. For a few quick hits (often requiring a modest, limited investment) that can create instant value for the tax function and the broader business, a tax executive can:

Focus on spreadsheet remediation

To drive processes and outputs, resource-strapped tax functions often rely on intricate spreadsheets that frequently forgo significant automation possibilities, use links that tend to become corrupted over time, and lack adequate version and access controls. Unfortunately, for many companies, spreadsheet maintenance tends to consume much of the tax function's time, leaving less time for quality review, data analysis, and process improvement.

Consequences of this inefficiency include inaccuracies, missed internal deadlines, tax compliance risks, tax-related material weakness, or significant deficiencies. Spreadsheet remediation enables companies to focus on value-added activities, such as improving the flow of information, ensuring the accuracy of source data, and spending time in review, instead of spending significant time and effort adding to already overly complex processes. Improving the effectiveness and control of your spreadsheets could prove useful if you are experiencing one or more of these common symptoms:

- Only one or two people really know how to use a critical spreadsheet
- No inventory of significant spreadsheets and the time it takes to execute them
- Highly complex spreadsheets (e.g., hidden cells, VB, XML, complex macros, internal and external links)
- Numerous data inputs or other spreadsheets that feed the master spreadsheet

Spreadsheet remediation may help companies develop a more consistent, flexible, repeatable tax process with strong linkage between tax and accounting and adequate controls integrated into the overall process.

Leverage Microsoft (MS) Access

Most tax functions use spreadsheets to manage large amounts of data that result in few calculations. A low-tech, budget-friendly way to collect and manage data for some of the more complicated book/tax differences can be achieved through MS Access. It is an underused application available to virtually every tax function.

MS Access can serve as a productive first step in prototyping applications via a more powerful database, such as SQL server. It can help tax functions visualize necessary system requirements and the corresponding user interface, which can then be migrated to the more robust SQL server database platform. However, it is important to coordinate the development with your IT organization so that data is secure and managed according to IT standards.

MS Access can be more effective than spreadsheets, given that it is a data management application, whereas spreadsheets are primarily intended to be computation tools with relatively little data management capability. It is a subtle, but important, difference because using the right application for the right task will lead to improved efficiency and better controls. For greater impact, consider integrating your spreadsheet computations with MS Access databases.

Sensitize tax ERP systems and differentiate high-risk items

First, tax must invest in training in the self-service tools available to gain ERP access, query, and report-critical information for tax reporting and planning. This includes the key ERP system tools that allow tax to directly access information rather than submitting a request to the controller's group and waiting for results.

It is likely the IT and/or finance functions will have deployed sophisticated ETL tools, consolidation programs, business warehouses, and/or data mart applications that enable finance to carry out its complex financial reporting role. One of the first steps in a tax technology improvement project is to look inside the organization, find these tools and applications, and discern how they can be configured to deliver on many tax function data requirements in a cost-effective manner.

Although spending is curbed during an economic downturn, some companies still want to improve their enterprise-wide process/technology and tax should have a seat at the table in these discussions. From a tax perspective, the decisions made during the blueprinting process can have a direct impact on whether the data is "tax sensitized" or will require significant manipulation outside the ERP system to meet multijurisdictional tax reporting rules.

Improve data management

Effective data management is a crucial enabler for the tax function. For the tax function to improve the quality of the data it receives, it must assume ownership by taking an active role in the data management processes throughout the organization.

In most cases, the tax function sees itself as a consumer of data—taking whatever is available in whatever format is provided and manipulating it to serve its needs. Tax technology system implementations are often begun with the goal of improving efficiencies and focus only on speeding up data manipulation without achieving the real efficiency dividend of enabling the tax function to be more proactive in managing the company's tax risks.

- Integrate ERP with tax reporting systems

  Tax should be actively involved in defining the data/reporting requirements for any ERP system. To successfully integrate those requirements into new system implementations, tax needs to help define its own data requirements for the overall business process. A 2008 Longview Solutions survey of 240 financial professionals found that organizations spend almost twice as much time collecting data as they do analyzing it, even though the accuracy of the data is their top concern.

  Much of this workload can be simplified by configuring ETL tools, business intelligence tools, and other systems designed to reduce time spent collecting, manipulating, and validating information. The result can be a substantial reduction in hours and overall risk—or, in other words, the efficiency dividend.

- Use third-party tax accounting software

  Many companies continue to rely on conventional—and often dated—spreadsheets that are prone to material misstatements through human error, broken links, or loss of the key developer.

TIP...

Implementations are more successful when they focus on strategic matters and not simply the tactical—getting data in the system and running parallel. For example, it is important to consider how to synchronize the provision and return; consider the statutory to GAAP audit adjustments; examine groupings (including segment reporting compared with tax return legal entity reporting); and analyze how to obtain and use tax-sensitive data embedded within your company's financial systems.

A 2007 survey conducted by the Association for Computers & Taxation (ACT) said 63 percent of respondents continue to use Microsoft Excel to compute their provision. However, companies may be able to realize meaningful efficiencies and improve their forecasting capabilities by using third-party tax accounting software, such as TaxStream, CORPTAX®, Longview Solutions, Vertex®, Planitax™, or one of the other commercially available systems. Third-party tax accounting applications tend to provide the most value when links are created to the ERP and/or financial consolidation system.

- Share resources

  In a down economy, an effective model to manage the talent gap for tax technology initiatives is to approach the CFO or controller about temporarily sharing a finance or IT specialist. Not only is a finance specialist familiar with the chart of accounts, but also a business case can be made based on the risk to the financial statements. Using any remaining budget, the tax accounting process consultant can vet issues after implementation with the company and its auditors.

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Option 3: deliver cash

One traditional cost-cutting measure is outsourcing. Although outsourcing has yet to impact most tax functions to the degree it has with IT, HR, and other functions at large companies, tax processes generally are not simple and are potentially more expensive to hand off to a third party than to retain in-house.

However, instances where outsourcing may be beneficial include helping a tax department scale its resources against fluctuating workloads, freeing up staff to concentrate on strategic imperatives and covering difficult staffing situations, such as reorganizations or headquarters relocations, but the cost savings may not be material. In fact, outsourcing may actually be more expensive—particularly if the company has not made appropriate technology and process improvement investments.

Outsourcing could also be used as the driver for needed technology and process improvements that may be too difficult to achieve internally. By managing scope upfront, the service provider can be charged with implementing process and technology enhancements, coupled with a planned transition of the work back to the company over time. Longer-term anticipated efficiency gains should be weighed against any increase in current costs.

From an operational viewpoint, the main opportunity to deliver cash may be to reduce fees spent globally with third-party firms for tax compliance and tax accounting by concentrating some of the data collection and distribution processes into an existing shared service center. Although this option will not and should not eliminate the need for third-party assistance, the cost savings—achieved through economies of scale, process efficiencies, and/or wage cost arbitrage—can be dramatic. Third parties will continue to provide valuable global coordination plus preparation and review services for technical accuracy in-country; however, concentrating the data collection and distribution processes in a shared service center can reduce fees or present a better opportunity to leverage those same third parties for planning advice. Not only can this approach deliver cash, but it is also a preparatory move to support global tax compliance and accounting processes in an IFRS environment.

Management of the global compliance function can be a difficult and time-consuming process, particularly when a company must deal with multiple advisers. Many companies have chosen to consolidate their global tax compliance function with a single service provider. The selection of a single service provider in conjunction with an effort to centralize data collection and distribution efforts into a shared service center could facilitate this change and result in additional efficiencies and cost savings.

Looking ahead—IRS ramps up as companies pare down

Historically, economic recessions in the United States have triggered an increase in Internal Revenue Service examinations and amended returns as a result of government efforts to generate needed tax revenue.

The current recession should prove no different. Bolstered by congressional support of a new administration and the desperate need for revenue given today's sizable budget deficit, the IRS is gearing up for record-setting increases over the next two years. By September 30, 2009, the LMSB (Large and Mid-Sized Business Division) is projected to increase by 12 percent, with a similar increase the following year (ending September 30, 2010). The Small Business Division will also expand over the next two years—adding approximately 1,800 revenue agents, 1,000 revenue officers, 1,400 campus auditors, and 800 tax compliance auditors.

Although taxpayers may see a temporary decrease in the volume of audits initially because of an enforcement lag associated with training new hires, IRS enforcement is projected to spike thereafter. Typically, recessions have enabled the IRS to attract more experienced revenue agents who can complete audits in less time—resulting in better audit coverage and an increase in both volume and quality of audits (particularly given the recent transition to e-filing, enabling the IRS to evaluate returns more quickly and employ better audit techniques).

Unfortunately for taxpayers, at a time where the IRS is ramping up resources, most companies will be paring down. This dialectic creates a problem as companies are certain to face a much more difficult controversy environment in the years to come.

As a result of the increase in IRS resources, some companies that have not been targeted for audit in the past may be targeted—further compounding resource issues and potentially draining needed cash.

Innovative thinking

Managing the economic challenges through 2009 and beyond will not be easy. Companies are rethinking their businesses and the tax function should be part of that innovative thinking.

By taking a fresh look at tax as part of the broader enterprise and evaluating the range of strategic options beyond simply cutting budgets and/or head count, CFOs and tax executives can tap into unrealized cost savings and the efficiency dividend. In this way, they can successfully manage through the weak economy and emerge with a tax function that is a value driver.

Connect

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