

Ask The Expert: Corporate Governance, Tax, and Technology

An Interview with Charles Rossotti

About Our Expert



Charles Rossotti, commissioner of the IRS from 1997 to 2002, is currently a senior advisor at The Carlyle Group, focusing on information technology–related buyout and venture investments. Rossotti also cofounded American Management Systems, Inc. (AMS) and for 27 years served in a variety of capacities, including president, chief executive officer, and chairman of the board. During his tenure AMS grew to become a major international business systems consulting and systems integration firm with revenues of more than \$1 billion. Mr. Rossotti holds an AB in Economics, magna cum laude, from Georgetown University and an MBA with high distinction from Harvard Business School.

Introduction

Corporate governance is a focus of concern in today's business climate, and it's increasingly affecting tax departments. Because tax-related issues played an important role in several of the most notorious recent corporate scandals, tax departments—in particular, the decisions they make and the internal processes they follow—are squarely in the spotlight. Managing tax risk has become a key part of preserving a company's reputation, and stakeholders are focusing on it like never before.

In this exclusive interview with former IRS Commissioner Charles Rossotti, we explored how corporate governance is impacting tax departments, and how businesses can leverage technology to enhance their strategic tax planning efforts while operating under increased scrutiny of processes and requirements for transparency.

Understanding Corporate Governance

Q: *There is a lot of talk about corporate governance these days. Can you provide a layman's definition of it?*

Rossotti: You're hearing a lot about corporate governance these days because, frankly, things went seriously wrong in a significant number of large publicly owned corporations. Top management violated trust through actions such as contrived or false reporting of financial transactions to inflate or manipulate results, and self-dealing between the corporation and its managers. Creditors, stockholders, and employees lost vast amounts of money as a result of these actions.

Q: There is a lot of talk about corporate governance these days. Can you provide a layman's definition of it? (con't)

In response, the public and its representatives in Congress demanded that those ultimately responsible for a corporation—its board of directors and chief officers, as well as outside advisors such as public accountants—take explicit steps to prevent such violations of trust from reoccurring. The Sarbanes-Oxley Act was the most prominent legislative result of this movement. Other regulatory bodies, such as the stock exchanges, also created new rules to address these issues.

These corporate regulations boil down to ensuring transparency and accuracy. Now, whenever a company makes a decision with financial consequences, it has to meet higher standards for defending that decision and proving that it is acting responsibly.

Corporate governance requirements affect many areas of an organization, particularly the finance, tax, operations, and accounting departments. There is a lower tolerance for error or noncompliance in all financially oriented reporting by a corporation, whether it's financial statements submitted to the public and the SEC or tax returns submitted to the IRS and to state tax agencies. Any executive involved in the financial record keeping of the organization must be concerned about executing—and proving—good corporate governance.

Q: How does this new emphasis on corporate governance affect the tax department?

Rossotti: Corporate governance demands close scrutiny of any large and highly variable element in a company's income statement and balance sheet—such as state, federal, and international taxes. Tax-specific controls are critical because tax represents one of the largest line-item expenses on a company's income statement. Taxes paid, tax assets and liability, and tax-related disclosures are essential parts of a company's financial statements.

Auditors know that pressure to meet earnings goals may tempt individuals within a company to adopt aggressive tax planning strategies or underestimate reserves for its tax contingencies. Potentially, a company could tweak the way it represents tax assets and liabilities to bring its ratios into apparent compliance with its debt covenants. Because tax offers so much potential for misrepresentation of a company's finances, management and independent accountants must now certify that a company's internal controls—in the tax area as well as many other areas—are designed well and operate effectively.

This new emphasis is a big change. It means no department that deals with financial transactions—including the tax department—is completely free to choose the methods by which it operates. Tax departments must establish and follow internal controls, so that they can identify financial reporting and disclosure risks related to tax management, reporting, and planning. Regardless of the type of tax being managed—international, federal, or state and local income taxes, or sales and use taxes—the department needs to be able to provide detailed information on choices made. Departments need to identify control activities and document, evaluate, and test the design and effectiveness of those controls.

"The accounting and reporting of income taxes has received increased scrutiny by investors, analysts, Congress, and others. Your auditor will be asking for more information, and you may have noticed an increased level of scrutiny from the SEC staff. That spotlight is likely to continue. Welcome to the new world."

*Donald T. Nicolaisen,
Chief Accountant, Securities and
Exchange Commission
February 2004*

Q: How does this new emphasis on corporate governance affect the tax department? (con't)

In short, with auditors demanding details of processes and supporting information, best-guess estimates are no longer acceptable. Even if the ultimate result of a tax calculation is correct, this is not enough. Tax departments can't just pull numbers out of a black box. Every decision and every piece of information must be backed by a transparent, documented, consistent, and auditable process. For most tax departments, this new requirement is going to drive major changes in how they operate, especially in regard to planning and record keeping.

“The real key—whether you are talking about performing specific tax calculations, interpreting and applying a new statute, or even negotiating an audit settlement—is to make the decisions based on review of reliable and complete data.”

Q: Tax executives are measured by the ETR*, which is reported on the company's financial statement, and they are also under pressure to minimize exposure/risk and cash taxes. Is it possible to minimize taxes while simultaneously minimizing risk?

Rossotti: It is possible to simultaneously minimize taxes and minimize risk. Minimizing taxes, whether as reported through the ETR or as reported and paid to the IRS and other tax agencies, means paying the least amount of taxes that the tax laws permit—every taxpayer is fully entitled to do this.

Minimizing risk means minimizing the chances that your calculation will be wrong—either inadvertently or because it is successfully challenged by the tax agency. Effective processes minimize the chances of inadvertent error, and make it easier to defend a position in an audit. Taking a position that may be challenged is not, in itself, risky. But taking a position without clearly documenting what you're doing and why—that poses unacceptable risk.

The real key—whether you are talking about performing specific tax calculations, interpreting and applying a new statute, or even negotiating an audit settlement—is to make the decisions based on review of reliable and complete data. The challenge faced by most—dare I say all—tax departments is that they don't have the means to produce a full, accurate view of their information. That level of information management can be achieved only through the application of sophisticated information systems, and until recently there weren't any tax management systems available. Luckily technology vendors have started to serve the complex needs of tax departments. Now it is up to tax executives to embrace these technological advancements and start making serious changes to their operations.

* ETR = Effective Tax Rate

Q: Do you see audit committees being more concerned these days with tax risk?

Rossotti: Yes, in two respects. First, Sarbanes-Oxley and regulations of the exchanges have increased the expectations that audit committees will address the areas of the company's business that create significant risk that the financial statement could be misstated. Since taxes affect the company's income statement, balance sheet, and cash flow in material ways, and since there are often important areas of judgment required to prepare the estimates that underlie the statements, taxes are an important part of this job. Similarly, the disclosures in the footnotes to the financial statements take on increased importance, especially when items such as tax assets may be on the books. This increased importance of tax risk means that in the audit committee's discussions with the CFO and the independent auditors, the subject of tax reporting will almost always come up.

Second, because of Section 404 in Sarbanes-Oxley, the audit committee must be concerned not only with the end result—namely the financial statements—but also with the processes that underlie the corporation's financial reporting. Management and the independent auditors must both attest to the soundness of these processes, and these attestations must be discussed with the audit committee. In practice, this requirement means that more transparency as to how the tax department arrives at and justifies its numbers must be present.

Proactively Managing the Impact of Corporate Governance

Q: What should companies do to manage tax risk and limit exposure while adhering to corporate governance guidelines?

Rossotti: Tax risk is complex and technical, so boards and senior management have in the past been content to rely on their tax experts to keep them on the right side of the law. Now they need to do more: implement an effective system of internal controls for managing tax risk, and make informed decisions about how much tax risk is appropriate for their particular organization. The tax department cannot be a mysterious black box, left alone to churn out a set of numbers for the financial statements and tax returns for tax agencies. It must be governed by internal controls, and what it does, and why, must be far more transparent.

Tax departments will have to review all their internal systems and processes to determine if they meet today's standards. Most departments have reasonable processes and systems for producing tax returns. But the majority will find they need to change processes and establish new systems, especially for planning and analyzing their tax positions over time and at all levels. They will need to upgrade their processes for making, supporting, and documenting the decisions and calculations that lead to their positions on tax returns and the tax provisions on the financial statements.

"The tax department cannot be a mysterious black box, left alone to churn out a set of numbers for the financial statements and tax returns for tax agencies. It must be governed by internal controls, and what it does, and why, must be far more transparent."

Q: What should companies do to manage tax risk and limit exposure while adhering to corporate governance guidelines? (con't)

Planning is newly important, because even if the corporate tolerance for risk hasn't changed, today's anti-abuse climate has ruled out many strategies tax departments have come to depend on. To optimize management of the company's tax exposure, a tax department needs to 'run the numbers' on changes to entity structure, integration of M&A, proposed and current legislation, audit settlements, transfer pricing, repatriation, filing options, and income or profit forecasting—and those numbers should take into account the way the picture changes across different taxing jurisdictions and multi-year time frames.

To optimize the management of tax exposure, tax departments need the ability to perform multi-year, multi-jurisdiction modeling and analysis of:

- ▶ Legal entity structure
- ▶ Integration of merged and acquired companies
- ▶ Proposed or current legislation
- ▶ Audit settlements
- ▶ Transfer pricing models
- ▶ Repatriation strategies
- ▶ Various filing options
- ▶ Income or profit forecasting

Q: Adhering to these new guidelines seems like a lot of added burden. Is there good news somewhere in this story?

Rossotti: Absolutely. In fact, there is a huge upside to meeting these new challenges. The requirement to upgrade is also a huge opportunity for a tax department to improve the effectiveness of its service to the corporation. By upgrading processes and systems, the department will be able to respond faster and more reliably to events—such as mergers and acquisitions, and changes in financial and cash forecasts—with greater confidence that it is appropriately minimizing taxes. They'll also be able to respond promptly and confidently to any inquiries, because automated systems can provide unprecedented levels of accuracy and transparency—which leads to defensibility. Instead of having to refer to a web of interlinked and complicated spreadsheets—with a dread feeling that errors are almost certainly in there—tax departments can produce detailed documentation on every decision, its financial consequences, and the alternatives considered.

Q: Do traditional systems and tools support these efforts?

Rossotti: Frankly, in most cases, they don't.

The internal systems and tools for tax departments started out in much the same way as those of most other departments. People used paper and pencil to make calculations and keep records, then used computer programs for a narrowly defined purpose, such as to produce a tax return or a spreadsheet to make calculations. But other departments, such as accounting and purchasing, moved on to vastly more sophisticated, integrated, and complete systems, such as ERP, while tax departments lagged. Tax departments still rely on ad hoc tools and processes that make it extremely hard, if not impossible, to meet current standards.

Let's look at consistency, for example. One of the obvious indicators of a problem to any auditor, whether that person is a financial statement auditor or a tax return auditor, is a set of positions that is internally inconsistent. One can defend a controversial position—whether it is on cost allocations, internal transfers and royalties, asset depreciation, or anything else. But it is hard to explain why the same position is good in one year but bad two years later, or good for one set of subsidiaries but bad for another set, or even good in one audit but bad in the next. Yet, when departments respond to issues case by case, pressure by pressure, ad hoc tools make it all too easy to fall into the trap of developing inconsistent and ultimately indefensible positions.

Q: Do traditional systems and tools support these efforts? (con't)

An article in the May 24, 2004, issue of Computerworld indicated that, "Anecdotal evidence suggests that 20% to 40% of spreadsheets have errors, but recent audits of 54 spreadsheets found that 49 (or 91%) had errors, according to research by Raymond R. Panko, a professor at the University of Hawaii."

As another example, let's look at the implications of relying heavily on spreadsheets. They're the only quantitative planning tool most tax departments have, but they were never meant to support modern standards for mission-critical processes, which must include rigorous audit trails, independent testing, highly defined procedures for updating, and tight controls over access. Instead, spreadsheets grow more complex and less transparent over time, increasing the risk of mistakes and even serious problems.

So look again at spreadsheets—from an auditor's perspective. They can be changed without any control process. They can contain errors from miskeying, inaccurate referencing, or cut-and-paste of bad data. Formulas might be wrong. Interfaces with other spreadsheets or systems might result in errors. There might be inappropriate definition of cell ranges, inappropriately referenced cells, or improperly linked spreadsheets. In short, spreadsheets are a gold mine for auditors. A recent Computerworld article indicated that 20 percent to 40 percent of spreadsheets contain errors. Another study noted that spreadsheets with more than 200 line items have a probability of error approaching 100 percent. Simply put, this error potential is unacceptable in today's business climate.

Technology and Corporate Governance

Q: What types of technological advancements are available to help tax departments meet these new requirements?

Rossotti: Responding to the critical need for modern enterprise-quality software for corporate tax departments, vendors such as Liquid Engines have begun to build rigorous systems that provide tax departments with the tools they need to minimize taxes while minimizing risk. Such tools adhere to all the requirements for mission-critical systems, while providing tax experts with vastly increased visibility into their options for minimizing taxes while staying compliant.

Simple compliance automation tools have been available for many years. Surveys indicate that 95 percent of corporate tax departments have applied computer automation to compliance (tax filings). What's new is advanced automation to support high-value activities, including planning and audit management. With corporate governance and anti-abuse legislation on the rise, tax departments must find defensible means to reduce their tax liability. Sophisticated tax planning software that can model different strategies across different jurisdictions over a period of several years helps tax departments mine their data to find ways to reduce tax liability through strategies such as repatriation practices, adjustments to entity structure, and proactive legislative analysis.

"With corporate governance and anti-abuse legislation on the rise, tax departments must find defensible means to reduce their tax liability. Sophisticated tax planning software that can model different strategies across different jurisdictions over a period of several years helps tax departments mine their data to find ways to reduce tax liability through strategies such as repatriation practices, adjustments to entity structure, and proactive legislative analysis."

Q: What features must the technology offer to properly address today's requirements?

Rossotti: Accuracy and transparency are absolutely fundamental to complying with corporate governance regulations. Companies must have a centralized and standardized information repository that provides an accurate, 360-degree view of their tax positions.

Reusable and tested business logic is important so that companies don't start with a blank slate each time they want to model a possible tax position. Technology must have embedded intelligence to drive efficiency, because there's no way any tax expert can rapidly double-check all the rules that might apply to a specific line item. In particular, technology needs embedded intelligence to provide multi-year, multi-jurisdictional visibility and assessment of tax positions.

Reporting capabilities are key, both to enable a company to make a decision and to justify the decision later, if need be. And ease of use is also important, because that will minimize the potential for errors and enable more people to leverage the technology.

Strategic tax planning that is transparent, accurate, and efficient offers a number of benefits, including:

- ▶ Increased visibility
- ▶ Improved ETR management
- ▶ Reduced risk
- ▶ Improved responsiveness to the business
- ▶ Enhanced utilization of resources
- ▶ Adherence to corporate governance guidelines

Summary

Transparency, accuracy, and control of tax planning are more critical than ever before. Relentless scrutiny of corporate governance, internal tax controls, and tax structures means that tax departments must not only respond with new ideas for defensible ways of reducing tax liability, but also back each decision with fully transparent and accurate documentation. New software makes it feasible, for the first time, to scour every financial detail of a company and the tax legislation that affects it to produce—and defend—new strategies for tax efficiency.

With application software, companies gain increased visibility into their tax positions—across multiple jurisdictions and multiple years. They discover possibilities they had not considered before, from adjustments to entity structure to better management of audit settlements that factor in impact over multiple years. Any one of these changes can have a substantial positive impact on a company's management of its tax liability and its ETR.

Even better, companies can be confident that their decisions conform to internal control processes, are based on accurate information, and have taken into account all the relevant and material data. Better documentation and tracking, improved processes, and enhanced accuracy enable tax departments to act with greater confidence than has been possible before.

By providing a company's tax experts with more accurate, comprehensive, and transparent information, and by automatically documenting analyses and decisions, technology can reduce the time they spend chasing information, building spreadsheets, and defending against audits. Instead, staff can work with the software to model optimal tax planning strategies that leverage their expertise to deliver dramatically greater value to the business and its shareholders.

About Liquid Engines

Liquid Engines is dedicated to furthering corporate financial performance by empowering today's tax professionals with sophisticated income tax management and planning automation. With Liquid Engines' breakthrough technology, CFOs and tax executives benefit from a previously unattainable level of transparency, accuracy, and efficiency. Corporate tax departments are now able to enhance their strategic value to the enterprise by minimizing tax risk, maximizing cash flow, increasing their responsiveness to the business, and adhering to corporate governance guidelines.

Liquid Engines software drives efficiencies into the tax planning process by bringing together silo tax functions and providing a single, fully integrated view of income tax information, enabling tax professionals to conduct efficient, accurate, and comprehensive modeling and analysis of even the most complex, multivariant scenarios. With Liquid Engines, Fortune 1000 companies now have the power to effectively manage ongoing tax implications of the business, regulatory, and legislative changes that impact their business, even within the most complex corporate structure.

Customers benefit from a rapid return on investment by leveraging Liquid Engines solutions to:

- ▶ *Optimize the global legal entity and capital structure*
- ▶ *Structure M&A transactions, spin-offs, and split-ups*
- ▶ *Optimize transfer pricing*
- ▶ *Measure the tax impact of proposed and current legislation*
- ▶ *Optimize filing elections*
- ▶ *Analyze the multi-year impact of proposed audit settlements*
- ▶ *Optimize a repatriation strategy*
- ▶ *Conduct Subpart F planning*
- ▶ *Analyze E&P*

Liquid Engines income tax management software offers the following key features:

- ▶ *Support for in-depth modeling and analysis over multiple years, across multiple jurisdictions, and entities*
- ▶ *Reusable, built-in tax calculations to speed the modeling process*
- ▶ *Self-documenting to ensure good record keeping*
- ▶ *Pre-defined and custom reporting options*
- ▶ *An intuitive interface enabling non-technical users to work with the system*
- ▶ *A central repository containing all relevant tax data*
- ▶ *Embedded tax rules that can be modified to meet specific business situations*

To learn more about Liquid Engines' breakthrough application software, call 408.585.9000, email info@liquidengines.com, or visit our website at www.liquidengines.com.