The essentials of value-added tax governance

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Tax governance has many moving parts, but for purposes of this discussion we will focus on two: risk management and best practices. It is important to note that governance is an on-going process that has to take into account a constantly changing tax environment including changes in regulatory policies, case law, tax reform, new technologies or many other factors that affect a business every day. A company's governance policy should encompass the changing footprint of the business itself that can occur through merger and acquisition activity as well as strategic changes. As companies enter new countries and face new tax rules, it is critical for them to review their tax compliance processes, reporting transparency and, most of all, their governance principles.

Since the enactment of the Sarbanes-Oxley Act in 2002, we have witnessed the rapid evolution of processes and controls being placed around many tax functions in order to improve general compliance, transparency and tax reporting performance. Collectively, we refer to these measures as tax governance.

At RSM, we are often asked to comment on, and help improve, our clients' tax governance. In order to do so, we need to examine several aspects of the client's tax environment, key among which are:

- Risk management policies, which seek to limit a business's exposure to tax and associated liabilities
- Best practices, which should be effective and measurable standards by which the business's tax efficiency may be ascertained

Next, we examine these two fields and consider how they could be applied to VAT, though the same principles could equally be applied to any tax type.

Risk management

The first thing to note is that every company's risk profile is different. Even associated companies in the same industry sector can look significantly different, depending on their global VAT and trading footprint. For this reason, each entity should be treated as a separate exercise when looking at risk management positions.

A tax risk management project should contain the following critical steps:

Identify risks

This is best done as a whiteboard exercise where all stakeholders add their own concerns to the conversation. We suggest the discussion cover two key topics:

1. Internal risks. These are risks that have their foundation in how the company is organized and the things it is doing. It looks at the activities over which the business has direct control. Examples of such risks might include changing supply chains, adopting a shared service center model, engaging in M&A activities or implementing a new financial system.
2. External risks. Examples here include factors over which the company has little or no control, such as the changing regulatory environment, the development of trade treaties between countries and changes occurring in their competitors' businesses.

Measure risks

The measurement of tax risk can take a number of forms. It may include:

- The quantum of the risk itself (i.e., the amount of tax at stake)

- Any potential associated penalties and interest
- Any reputational risk that may be involved
- And even whether the risk could be a "stop-the-show" issue.

It is worth noting that, in the VAT world, failure to register and account for tax correctly can lead to interruption of the business's supply chain, financial penalties or even criminal prosecution. When measuring risk, all aspects of those risks must be taken into account.

Prioritize risks

Once the risks have been identified and measured, the business should be in a good position to start prioritizing those risks. If this is the first time this exercise has been carried out, it is easiest to create a graphic, as shown below, which we have populated for a fictitious, multinational company. It helps identify risks against the axis of probability and the axis of impact. Once all identified risks have been placed in one of the four boxes, it makes clear where the business should focus its efforts in terms of addressing its tax risks.

		IMPACT	
		MINOR	MAJOR
PROBABILITY	HIGH	▪ Readiness for e-filing ▪ VAT registration issues ▪ Supply chain changes	▪ European Union VAT reform ▪ Real time VAT reporting ▪ Global hyper-regulation ▪ International expansion and M&A activity
	LOW	▪ Export documents ▪ EU VAT simplification ▪ Outsouring processes	▪ Introduction of VAT in United States ▪ Acquisition of competitor ▪ Move to shared service center model

This type of analysis can be done at many levels such as by tax type, by country, by business division, etc., but it is critical the information is rolled up to higher levels to provide a broader, global overview of the company's risk profile. Additionally, these frameworks should be living documents, since new risks will emerge regularly, existing risks will change priority and resource capabilities can fluctuate. We recommend revisiting the risk frameworks on a quarterly basis to ensure their relevance, and to provide guidance on the parts of the business that should be areas of focus for the tax department.

Managing risks

A key to this process is to recognize that it is highly unlikely risk can be completely eliminated. However, with an effective risk management approach, the risks can become known, quantified and appropriately addressed. This may mean creating reserves to address those risks, if they should become a reality, or it may mean simply creating awareness that the risks exist in order to avoid unpleasant surprises further down the road.

There are essentially four routes that can be taken to manage VAT risk, and the most appropriate will differ from company to company, and situation to situation. The four routes are:

- **Avoid risk**. For example, restructure or even decline a high-risk transaction.
- **Transfer or share risk**. Use agents, partners, distributors or outsourcers who could share in the risk.
- **Reduce its likelihood**. Consider initiating best practice processes and adopting automated solutions.
- **Reduce its effect**. Create provisions or reserves against recognized risks, thereby reducing any adverse impact.

As this simple approach becomes embedded in the organization, it will mature and grow into a more targeted, sophisticated process over time. It is critical, however, that the company not treat this as a one-off exercise but instead approach these issues as part of a proactive, disciplined path to an effective risk management process.

Best practices

A best practice can only be described as such if it is aligned with the business's vision and strategy on the one hand, and with the company's legal and regulatory obligations on the other. Best practices have, in part, taken over some of the space previously occupied by tax planning activities. Since the passage of SOX and more recent legislation, we have seen a significant switch in the consulting profession from tax planning to a much more compliance-based focus. It could be argued that good compliance practices are, in many ways, equivalent to good planning and that best practices will lead in many cases to a positive result, especially in an area such as VAT, where so much working capital can be tied up.

In many organizations, best practices are underpinned by key performance indicators (KPIs), which are the standards that the business holds itself to, and against which it is measured when looking at its tax performance. KPIs may be both qualitative and quantitative and, as mentioned earlier, should align with business goals and—critically—the individual performance goals of the tax team members.

Many businesses will start by creating an inventory of metrics that will be used to measure performance. It may be useful to group metrics under a handful of key headings or categories as highlighted on the next page.

Metric: **Timeliness**

KPI	Description	Target	Measurement
Return preparation timeliness	VAT returns to be prepared and reviewed no later than five days prior to submission deadline	100% compliance	
Return submission timeliness	VAT returns submitted electronically by deadline date	100% compliance	

Metric: **Accuracy**

KPI	Description	Target	Measurement
Control checks completed	General ledger reconciliation and 85% of VAT return control checks to be completed prior to return submission	100% compliance	
VAT returns accuracy	VAT returns do not require amendment and do not give rise to tax assessments on audit	99% compliance	

Other metrics may include:

- Efficiency (e.g., number of returns completed per member of staff)
- Completeness (e.g., all necessary financial reports received and processed on time)
- Auditability (e.g., all accounts reconciled and clear audit trails)

Identifying the most appropriate KPIs for the business creates a template around which the tax team can develop their work processes and will drive focus on the most important aspects of the team's efforts.

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