

Indirect tax reporting in the new environment

Findings from a global survey

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“ An increasing number of in-house indirect tax managers are facing up to the challenge of creating an indirect tax strategy that is more closely aligned with the business objectives of operational integrity and the promotion of shareholder trust ”

Managing and Monitoring Indirect Tax: Our View



The environment for indirect taxation has become increasingly complex over the past five years. With the globalization of business and the removal of some barriers to international trade through more effective use of technology, companies find themselves having to invest more and more in tracking and accounting correctly for Value Added Tax (VAT) or Goods and Services Tax (GST). There is a growing recognition that far from being a ‘work-through’ tax for business, the error rate in VAT/GST imposes high costs in management time and reduces cash flow, which impacts on shareholder value. As both national and international courts continue to evolve a concept of ‘abuse of law’, local tax authorities are also promoting assurance and anti-avoidance/evasion strategies, including disclosure and special accounting requirements under derogations from the normal rules, that place a significant compliance burden on the internal indirect tax function. At the same time, the drive towards value-optimized procurement and distribution functions – either on a regional or global basis – has greatly complicated transactional reporting obligations for most major multinationals.

In addition, there is an increasing trend for governments and revenue authorities to play closer attention to the Custom and Excise Duties (C&ED) reporting obligations of companies trading in and out of their territories and there are signs

of increasing co-operation between revenue authorities from different jurisdictions in this area as well as for VAT/GST. This combination of external regulatory factors and changed operational priorities has resulted in a significant increase in the profile of indirect tax risk within multinational organizations.

To better illustrate and highlight the challenges faced by business in managing their indirect taxes, Ernst & Young commissioned Taylor Nelson Sofres to carry out research among tax directors and CFOs around the world on how they handled their indirect tax burden.

Many major multinationals now include one or more indirect tax specialists within their internal tax function. However, the way in which they are used tends to mirror the traditional consulting model: the specialist adviser sits centrally within the tax function, responding to individual queries raised by logistics managers, accounting staff and local business units. As our survey shows, central visibility of the VAT/GST and C&ED compliance issues affecting local country operations tends to be patchy at best, with little or no continuity in the management of local indirect tax risk across the organization as a whole.

An increasing number of in-house indirect tax managers are facing up to the challenge of creating an indirect tax

strategy that is more closely aligned with the business objectives of operational integrity and the promotion of shareholder trust.

Central to this development is a growing recognition that the effective management of indirect tax risk requires an operational as well as technical focus, including cutting across organizational lines to communicate indirect tax risk issues to non-tax staff who deal with the day-to-day operations and processes that can actually give rise to those risks.

Failures in systems and processes can result in overpayments of VAT/GST that represent a real cost to the business or in under-declarations that potentially lead to penalties and reputation risk, ultimately increasing the likelihood of tax audits and the further administrative burdens that go with them. By working with the internal IT and finance functions, the in-house indirect tax function can help identify latent risks within existing systems and processes. Equally, failure to appreciate the practical complexities of physically shifting goods in and out of markets and through the supply chain tends to result in a real lack of central knowledge regarding VAT/ GST and C&ED exposures. Often it will only be the local commercial procurement or sales manager, and occasionally the finance director, who sees what is going on.

By gathering and centralising this information for all indirect taxes throughout the supply chain, companies can build an indirect tax risk framework to help minimise operational errors and identify opportunities for genuine tax planning that reflects the commercial operations and needs of the business.

The objective of the internal indirect tax function should be to assume overall strategic responsibility to the Board for the operational integrity of VAT/GST and C&ED systems and processes. However, the allocation of roles and responsibilities will naturally depend on the specialist resource made available by the Board to the in-house function as well as the internal operating structure of the organization. For example, if the organization has chosen to centralize its transactional processing, accounting and reporting functions at a shared service centre, it may be possible to make specialist indirect tax resources available on-site to ensure prompt resolution of queries and to proactively audit the systems and advise the IT departments on IT systems changes appropriate to new or altering supply chains.

Where responsibility for indirect tax management remains in the local markets, a different control environment may be appropriate, possibly with local financial controllers required to act as key stakeholders in the tax management process. The

important point is that, whatever the operational structure, the indirect tax function should take responsibility for designing appropriate controls, documenting those controls and ensuring their operational effectiveness throughout the organization to reduce risk to the financial robustness of the systems in place.

For organizations with significant geographical reach, diffused responsibility for indirect tax accounting processes, or complex technology systems, improving the operational management of indirect taxes represents a sizeable challenge. In meeting this challenge, the internal indirect tax manager will necessarily redefine their role and raise the profile of indirect tax within the organization.

By redefining the indirect tax strategy, giving it an operational as well as a technical focus, and aligning the strategy to the key business objectives of transactional integrity and financial reporting accuracy, the in-house function can make a valuable and valued contribution to the organization as a whole.



Survey Findings

High confidence in systems but low visibility?

The survey findings show

- A small number of tax directors and CFOs admitted that there was no central visibility of the value of VAT/GST being managed through their supply chain – 12% globally; 15% in North America; 13% in Europe and 6% in Asia-Pacific.
- Of those that did have central visibility of the value of VAT/GST being managed through their supply chain, a quarter of survey participants globally estimated the value of that VAT/GST flow as being between US\$100-500m. A small number (3%) estimated the value at greater than US\$5 billion. A large minority, however, felt unable to state a figure (44% globally).
- When asked how many VAT/GST and Customs tax professionals their companies employed, between 35-40% of survey participants said ‘none’ while around another third said that they didn’t know. A few survey participants claimed they had 10 or more indirect tax professionals but positive answers, on average, were in the range between one and three.
- Survey participants were reasonably confident that their financial systems could accurately calculate and report VAT/GST through their supply chain (See figure 1).

Globally, a third of tax directors and CFOs said that they were ‘very confident’ in their financial systems. In Asia-Pacific the number of tax directors and CFOs who were ‘very confident’ leaps to nearly half (49%), while in North America, tax directors and CFOs were more cautious in their assessment, with the number saying that they were ‘very confident’ being just under a quarter (23%).

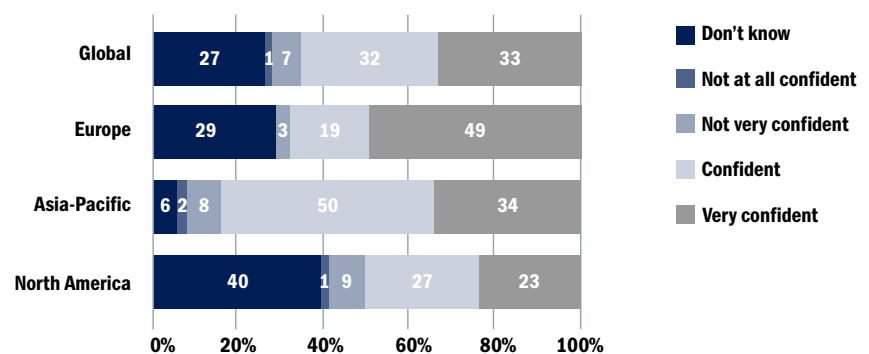
- Levels of confidence remain relatively high even when looking at the responses of those survey participants who said there was no central visibility of VAT/GST in the supply chain. Nearly half (46%) of the respondents who said that there was no central visibility went on to say that they were ‘confident’ in the accuracy and reporting of their VAT/GST and Customs duties.

- Companies that had experienced an indirect tax audit tended to be more confident in the accuracy of their financial reporting systems than those who had not.

Commentary

That tax directors and CFOs can express such high levels of confidence in their indirect tax reporting systems would normally be encouraging but should be done against a backdrop of lack of transparency and knowledge set alarm bells ringing? There are some possible explanations. VAT/GST has been long established in Europe and there may well be assumptions being made that since the group has had to handle VAT/GST across the European Union for many years, the systems for doing so are well established and running smoothly. Such confidence may well be justified when it appears that those companies that have

Figure 1. Confidence in systems



How confident are you that your financial system(s) accurately calculate and report VAT/GST throughout your supply chains?
 Sample Bases: Global (399), North America (100), Europe (224), Asia Pacific (75)

experienced an indirect tax revenue authority audit are more confident about the accuracy of their systems than those that have not.

In many multinationals the management of these taxes is handled at a level much lower down than the CFO or tax director. In the case of C&ED, the responsibility for handling them may well be outside the tax function entirely, resting instead with country commercial or operations managers and directors. In 2004, Ernst & Young's report on global customs best practices noted that the recognition of the customs and trade function as having a significant impact has increased substantially in recent years. Responsibility for the function is nevertheless often fragmented and information flows are inconsistent and uncoordinated.

The reality, however, given the general size of value flows, the penalties for errors and the ease with which VAT/GST can be mismanaged in internal IT systems, is that VAT/GST has reached the point where it needs to be viewed in a consistent and consolidated way across the group as potentially a major financial global risk.

A focus on internal controls

The survey findings show

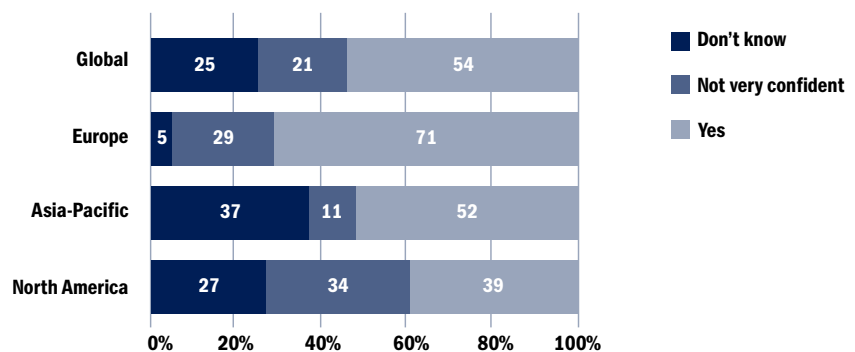
- More than half (54%) of the survey participants say that they include VAT/GST reporting or planning as

part of their internal controls assessment (See Figure 2). The number of positive responses is highest in Europe with more than seven out of ten (71%) saying that they included VAT/GST in their internal controls assessments. In North America just over half (52%)

internal controls compared to just under four out of ten (39%) in Asia-Pacific. North America had the largest number of survey participants who answered 'don't know' - 37% - compared to Europe's 5% and Asia-Pacific's 27%.

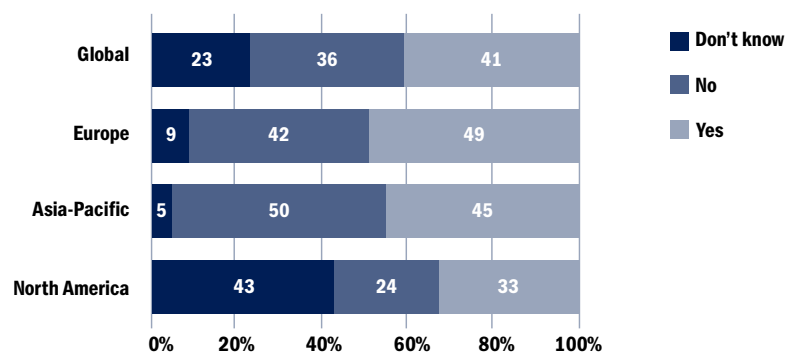
- Four out of ten (41%) of tax directors and CFOs globally said that they

Figure 2. Europe leads on internal controls assessments...



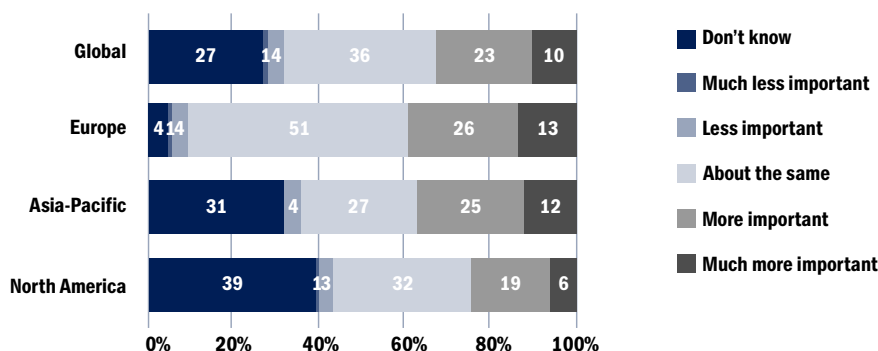
Do you include VAT/GST reporting or planning as part of your assessment of your company's internal controls?
 Sample Bases: Global (399), North America (100), Europe (224), Asia Pacific (75)

Figure 3. ...and you see the same picture for Customs & Excise Duty



Do you include Custom & Excise reporting or planning as part of your assessment of your company's internal controls?
 Sample Bases: Global (399), North America (100), Europe (224), Asia Pacific (75)

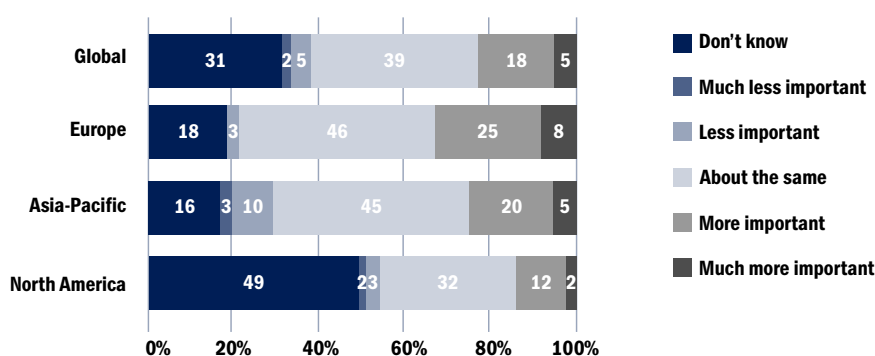
Figure 4. Split views over the growing importance of VAT/GST to business operations



Compared to two years ago, how would you describe the level of importance of VAT/GST to your current operations?
 Sample Bases: Global (399), North America (100), Europe (224), Asia Pacific (75)

included C&ED in their internal controls assessments (See Figure 3). As with VAT/GST, Europe led the way with nearly half (49%) of survey participants saying they included C&ED compared to 45% in Asia-Pacific and a third (33%) in North America. Unlike their counterparts in Europe (9%) and Asia-Pacific-Pacific (5%) a large proportion (43%) of tax directors and CFOs in North America didn't know whether C&ED was included in their internal controls assessments.

Figure 5. A minority see Customs as increasing in importance but uncertainty remains high



Compared to two years ago, how would you describe the level of importance of Customs and Excise Duty to your current operations? Sample Bases: Global (399), North America (100), Europe (224), Asia Pacific (75)

Commentary

This is a vital area. European respondents' knowledge of whether the taxes covered by this research are included in internal controls assessments is understandable since companies operating in those markets have potentially greater exposure to those taxes.

An emerging recognition that indirect taxes are becoming more important

The survey findings show

- A third (33%) of tax directors and CFOs globally view the levels of importance of VAT/GST to their operations as either 'more important' or 'much more important' than two years ago. Around another third (36%) take the view that it is about the same, with a small minority (5%) viewing it as

either 'less important' or 'much less important' than two years ago. However, a quarter (26%) of tax directors and CFOs feel that they simply don't know.

- Companies in Europe and Asia-Pacific view VAT/GST as becoming 'more important' or 'much more important' than the global average (39% for Europe and 37% for Asia-Pacific) compared to North America where the figure (25%) is less than the global average. Europe, however, has the greatest number of companies (51%) who feel that VAT/GST is about the same in importance as it was two years ago (See Figure 4).
- Nearly four out of ten (39%) of tax directors and CFOs globally feel that customs duties carry about the same level of importance to business operations as they did two years ago

(See Figure 5). However, there is a clear group of nearly a quarter (23%) of survey participants who feel that they are either 'more important' or 'much more important' than two years ago. As with VAT/GST, there are significant proportions who feel that they simply don't know (31%).

- More companies in Asia-Pacific view Customs as having a greater role than two years ago compared to elsewhere. In Asia-Pacific a third of tax directors and CFOs say that Customs is either 'more important' or 'much more important' than two years ago compared to 25% in Europe and 14% in North America. However, in Europe and Asia-Pacific respectively, 45% and 46% of tax directors and CFOs feel that Customs has about the same importance as two year ago. In

North America nearly half (49%) of survey participants don't know whether Customs is becoming more important or not compared to 16% in Europe and 18% in Asia-Pacific.

Commentary

That the market is split in its views of indirect taxes – both VAT/GST and C&ED – is not particularly surprising, although there is some comfort to be taken from the views of the quarter to a third who see the importance of these taxes to their operations as increasing. As with other tax disciplines it is likely that what we are seeing here is the emergence of a group of practitioners who are starting to ‘get it’ from an indirect tax perspective and are willing to take the appropriate steps to identify and manage their exposures centrally rather than solely at the local level. What is certainly very striking is the way in which Europe appears to be ahead of North America in this regard. In many other areas of tax operations, whether around risk management; tax accounting and internal controls management; or international taxation, it is normally the other way around. Given the increased spread of indirect taxation around the world there may well be lessons here that can be learned by North American companies when considering what they should do next. From the Asia-Pacific perspective, there

is generally a pattern of much tougher enforcement and penalties for failure to comply with indirect tax reporting requirements and so attitudes are more sensitive than in North America.

Some consistent priorities but differences exist

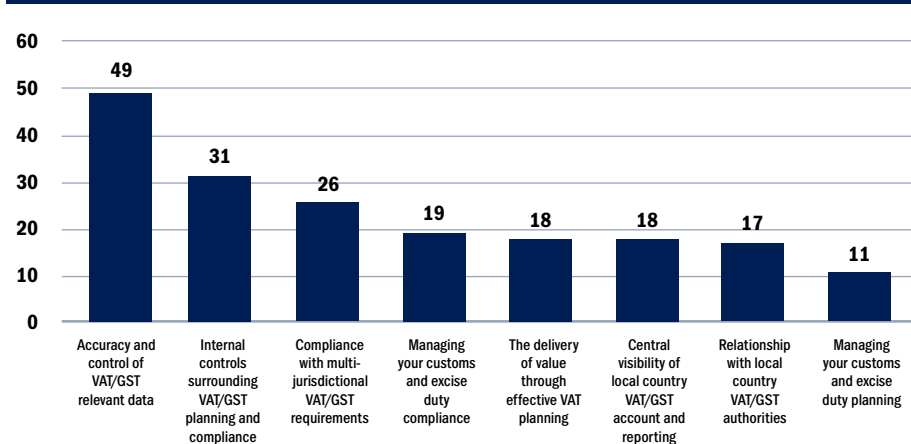
The survey findings show

- Tax directors and CFOs around the world see ‘accuracy and control of VAT/GST relevant data’ (49%); internal controls surrounding VAT/GST planning and compliance’ (31%) and ‘compliance with multi-jurisdictional VAT/GST requirements (26%) as their top

three VAT/GST and Customs planning and management priorities (See Figure 6).

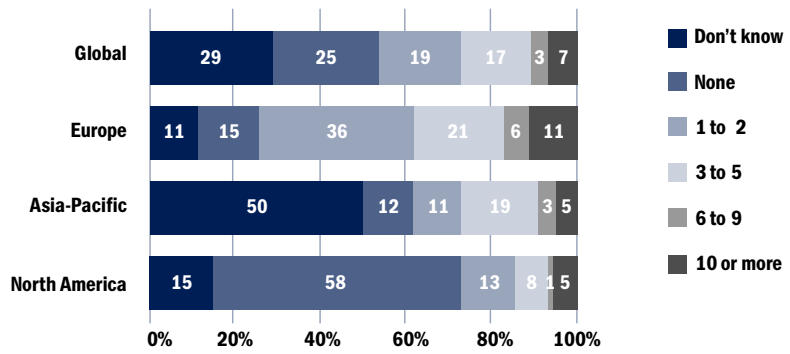
- The same picture is broadly true of North American and European survey participants, where these three priorities also represent their top three areas of concern. However, what does differ is the extent to which these are viewed as priorities. European tax directors and CFOs place much higher importance on the three leading priorities than their North American counterparts. For example, in North America ‘accuracy and control of VAT/GST relevant data’ is viewed as a priority by 35% of respondents. For Europe it is 58%.

Figure 6. VAT/GST priorities for tax directors and CFOs around the world



Which of the following planning and management activities do you consider to be the most important priorities from a VAT/GST and Customs & Excise Duty perspective at the present time? Sample Bases: 399

Figure 7. VAT/GST audit experience



Across the countries in which you operate, how many indirect tax audits by the relevant national tax authorities have you experienced in the past two years? Sample Bases: Global (399), North America (100), Europe (224), Asia Pacific (75)

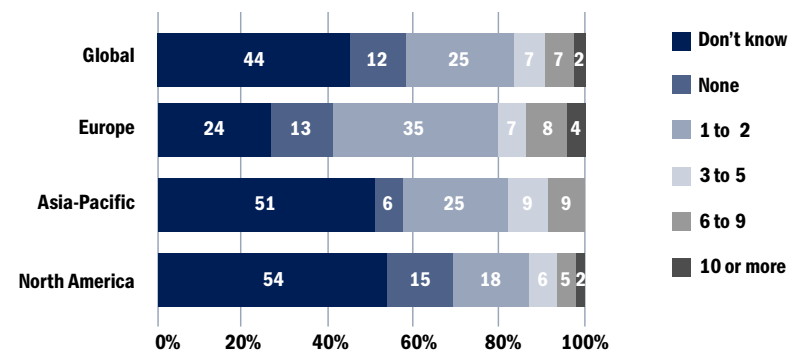
- In Asia-Pacific the picture is slightly different – while ‘accuracy and control of VAT/GST relevant data’ is the overwhelming number one priority (60%), ‘central visibility of local country VAT/GST accounting and reporting’ along with ‘managing your customs and excise duty compliance’ are the second (31%) and third (26%) priority areas.

Commentary

Tax directors and CFOs have a clear understanding of where their priorities lie and what would need to be done to remedy them. Their focus is on ensuring, for indirect tax as for corporate taxes generally, that they are meeting their reporting and other compliance requirements.

The importance they place on the accuracy of data and the operation of internal controls suggests that there is a recognition of knowledge and process gaps, and maybe of lack of expertise too, in spite of the confidence expressed in answers to some of the other questions we asked. What also becomes apparent is that while most companies have a ‘wish list’ of other indirect tax activity, such as planning, they are not necessarily in a position at this point to devote the required time and resource to make these things happen.

Figure 8. Customs & Excise audit experience



Across the countries in which you operate, how many indirect tax audits by the relevant national tax authorities have you experienced in the past two years? Sample Bases: Global (399), North America (100), Europe (224), Asia Pacific (75)

Who's watching?

The survey findings show

- More than half (54%) of tax directors and CFOs globally either don't know that their company has experienced a VAT/GST audit by a national tax authority or they believe that the answer is none (See Figure 7). That global picture is heavily influenced by tax directors and CFOs in North America where half (50%) don't know and a further 12% do not think that they have had a VAT/GST audit across the countries in which they operate in the past two years.
- Survey participants in Europe report the greatest number of tax audits,

with 13% of tax directors and CFOs saying that they have experienced VAT/GST audits in six or more countries in the past two years. A majority of Asia-Pacific tax directors and CFOs believe (58%) that their companies have not experienced any VAT/GST audits in the past two years although a small number (6%) say that they have had VAT/GST audits in six or more countries in the past year.

- When it comes to Customs and Excise Duty audits the numbers of ‘unknown’ responses climb even higher (see Figure 8). At a global level, 44% of tax directors and CFOs do not know whether their company has experienced a Customs audit in the past two years.

- In North America the number of ‘unknown’ respondents is more than half (54%), closely followed by Asia-Pacific (51%). In Europe the number is relatively smaller (24%). Europe also has the highest number of Customs audits with 12% of tax directors and CFOs reporting audits in six or more countries in the past two years.

Commentary

Traditionally, indirect taxes are handled at a much lower level within the organization than the CFO or tax director, and so these levels of responses are a reflection of that fact. However, it is becoming increasingly clear that this is not an area where devolved or decentralized responsibility can be easily afforded. At a time when the link between corporate reputation and its financial management is at its most prominent for a lifetime, there is a strong argument for much greater awareness of where the company has made serious over or under declarations, experienced other compliance or liability problems or faced challenge or investigation by the revenue authorities in the area of indirect tax.



About the Survey

In 2005, Ernst & Young commissioned an independent survey of tax directors and CFOs in 16 countries/tax jurisdictions (See Figure 9). Around 25% of the respondents were from North America, 20% from Asia-Pacific and the remainder from Europe.

Professional independent researchers at Taylor Nelson Sofres conducted the interviews, using a universe and sample made up of the largest corporations in each country (See Figure 10).

Interviews were carried out with the person having responsibility for the purchase of tax services. Most often this was the tax director but sometimes (34%) included the CFO or director of finance. Interviews were carried out in the third quarter of 2005. The results of the survey are presented as a percentage of all responding companies.

Figure 9. Countries / tax jurisdictions involved in the survey and number of respondents

Country	Interviews 3Q05
Australia	25
Belgium	22
Canada	16
China/HK/Korea	25
France	25
Germany	28
Italy	26
Japan	25
Netherlands	25
Nordic	25
Spain	26
Switzerland	22
UK	25
USA	84
TOTAL	399

Figure 10. Size of companies surveyed

Turnover	Interviews 3Q05
Greater than \$3bn	107
Between \$1-3bn	134
Less than \$1bn	158

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