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University of the Witwatersrand, Johannesburg

A research report submitted to the Faculty of Commerce, Law and Management in partial fulfilment of the requirements for the degree of Master of Commerce

INTEGRATION OF TAX AND INTERNAL AUDIT FUNCTIONS TO IMPROVE TAX RISK MANAGEMENT

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ABSTRACT

Risk management is an important part of business as some risks can threaten the continuity of the business. As part of risk management, organisations need to manage tax risks as tax errors have the potential to cause significant financial loss and also carry reputational and other business risks which can threaten the continuity of the business.

When considering tax risks in general, it can be said that taxpayers have a risk that they are not paying the correct amount of tax. This could be could be the result of applying the law incorrectly or configuring the system incorrectly to determine the tax results of the business activities and operations. Tax professionals have the expertise to identify tax risks and recommend corrective measures from a tax technical / legal point of view, which can address both past and future risks. Internal auditors on the other hand, have the expertise to detect tax risks and recommend corrective measures from a procedure and systems point of view, which may often only address future risks.

The aim of this research is to gain a better understanding of the concepts of tax risks, tax risk management, as well as the process of designing, implementing and testing internal controls to manage those risks. This will specifically include an analysis of the role of the tax function and internal audit function in effectively managing tax risks, particularly through integration.

Key words:

Tax, internal audit, tax risks, controls, internal controls, tax risk management

DECLARATION

I declare that this research report is my own unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation) at the University of Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

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Sanelisiwe Sambo
14 September 2017

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TABLE OF ACRONYMS AND ABBREVIATIONS UTILISED IN THE REPORT

BEE	Black Economic Empowerment
CAE	Chief Audit Executives
CFC	Controlled Foreign Company
COSO	Committee of Sponsoring Organisations of the Treadway Commission
DTT	Deloitte Touché Tohmatsu
EY	Ernst and Young
GT	Grant Thornton
KPMG	KPMG
RBIA	Risk Based Internal Auditing
PBO	Public Benefit Organisation
PWC	PricewaterhouseCoopers
SARS	South African Revenue Service
HMRC	Her Majesty's Revenue and Customs
IIA	Institute of Internal Auditors
IOD	Institute of Directors
ITA	Income Tax Act
ISA 330	International standards of auditing 330: The Auditor's Responses to Assessed Risks
OECD	The Organisation for Economic Co-operation and Development
SA	South Africa
TRM	Tax Risk Management
TRMCF	Tax Risk Management Control Framework
UK	United Kingdom
USA	United States of America
VAT	Value-Added Tax
VAT Act	Value-Added Tax Act

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1. CHAPTER 1: INTRODUCTION

1.1. Overview

The role of internal audit according to the Institute of Internal Auditors ("IIA") (n.d) is to provide independent assurance that an organisation's risk management, governance and internal control processes are operating effectively. The assurance provided should also cover risk management, governance and internal control processes in relation to tax risks. It follows that; tax risk management should be covered as part of this assurance activity.

The tax risk management process is about understanding where the tax risks arise and making judgement calls as to how they are dealt with (Elgood, Paroissien, & Quimby, 2004; 2). This process should aid the effective management of tax risks. In a business, there may be various people covering risk management - this raises the following questions in relation to tax risks: who has the responsibility to ensure that tax risks are managed effectively? Is it the tax function? Is it the internal audit function? Or is it both?

Most professional services firms have tax specialists who perform tax risk reviews and recommend corrective measures for historical risks as well as controls for future risks. Do the internal auditors in professional services firms also perform the same duties when performing an internal audit of the tax affairs of the business? Is there any value to be added by the tax and internal audit professionals working together in the planning and execution of the review? Can the historical as well as future tax risks be managed effectively through this integration?

Some of the professional services firms in South Africa ("SA"), the United Kingdom ("UK") and the United States of America ("USA") have a special service offering which looks at tax risks from an internal audit perspective and have published material on why this should be done and how it can be done.

One of the reasons provided by Ernst & Young (2013) as to why tax risk should be looked at from an internal audit perspective is that, due to the complexity involved in managing tax risks, participation from different stakeholders with the required skills is required to partner with the business and the tax function to properly assess, correct and monitor the tax risks found in the organisation.

> "Internal audit can, and should, play an integral role in the organization's broader tax risk management approach." (p.8)

One way in which the internal audit function can play an integral role in the organisation's broader tax risk management approach is by including tax in the risk assessment and in the Internal Audit plan. Bringing tax into the regular internal audit cycle is crucial because:

- Taxes are complex;
- Transactions might be impacted by a variety of taxes;
- Tax legislation and practice change regularly;
- Technology and processes are often not customised for tax requirements;
- Tax expertise is often not available at operational level; and
- Tax risks are often ignored in enterprise risk assessments.

The subject of tax risk management has been researched and documented before; however, no specific attention has been paid to internal audit as a way of improving tax risk management.

The objective of this research, significance, delimitations as well as research methods are discussed below.

1.2. Objective of the research

1.2.1. The research question

1) How can tax risk management be integrated into the internal audit function?

The purpose of this research is to perform an interpretive analysis of the relationship between tax and internal audit and how businesses can make use of this relationship to get better value out of the internal audit cycle / process in relation to tax.

1.2.2. The sub-questions

The following sub-questions will assist in attempting to address the main research question as detailed above.

1) What is the role of tax in tax risk management?

2) What is the role of internal audit in tax risk management?

3) What are the benefits of the internal audit function involving the tax function in the internal audit plan of tax risks?

4) Based on the experiences noted from the work done by tax and internal audit professionals in South Africa, United Kingdom and United States of America, what value can be added by tax experts in designing and executing the internal audit plan or performing the internal audit of tax risks?

1.3. Significance of the study

In many instances, the internal audit function conducts internal audit reviews, including a review of the tax environment with limited involvement of subject matter experts. Similarly, tax subject matter experts conduct tax risk reviews with limited involvement of internal audit specialists. One would think this would not be the case as both functions conduct the review to identify risks and make recommendations to mitigate those risks. This approach is different from the approach followed by external auditors when performing annual external audits as such audits are often performed with in collaboration with tax specialists.

From the work done on tax risk management over the years, as well as the service offering introduced by a few professional services firms, it is evident that there is value to be added to internal audits by integrating the tax function into the internal audit function.

This study is meant to provide insight into the roles and responsibilities of both the tax and internal audit functions in managing tax risks. The study is also meant to analyse the value that can be added to internal audits using various tax risk management material, professional services offerings introduced in recent years and in particular, literature in relation to integrating the tax function into the internal audit function.

1.4. Delimitations of the research

The research is exploratory in nature. It is based on an interpretive approach and will focus on the internal audit processes in a tax environment and how the internal audit process can be improved to effectively manage tax risks. This study is limited only to literature review on this topic, as such; it only includes qualitative research on this topic. Quantitative research is beyond the scope of this research and is therefore deferred for future research (Section 6.2).

1.5. Research methodology

The research method adopted is of a qualitative, interpretive nature, based on a detailed interpretation and analysis of amongst other things, books, journals and online sources.

An extensive literature review and analysis will be undertaken that includes the following sources –

- Books
- Electronic databases
- Electronic resources - internet
- Journals
- Magazine articles
- Publications
- Statutes

1.6. Chapter outline

The chapters are structured to understand tax risks and the processes to manage them effectively.

Chapter 2 will analyse the concept of tax risks.

Chapter 3 will analyse the tax risk management process.

Chapter 4 will analyse the internal audit process.

Chapter 5 will present the theories and articles relevant to the topic of ‘integration of tax and internal audit functions to improve tax risk management’.

Chapter 6 will summarise on the findings of the research and propose areas requiring further research.

2. CHAPTER 2: TAX RISKS

2.1. What is tax risk?

The decisions, activities and operations undertaken by an organisation give rise to various areas of uncertainty – business risks. Some of these uncertainties will be in respect of tax. These tax uncertainties may be in relation to the application of tax law and practice to particular facts, it may be uncertainty over the facts themselves or it may be uncertainty as to how well systems operate to arrive at the tax results of the business activities and operations. These uncertainties give rise to tax risk. (Elgood et al., 2004:3)

According to Deloitte South Africa (2016), the general overall tax risks are as follows:

- Paying too much tax;
- Paying too little tax; and
- Non-compliance with tax legislation.

In support of this view, over the years, a number of tax cases have shown that tax risks can have a significant financial impact in the form of taxes, penalties and interest payable to revenue authorities. In addition to the financial impact, tax risks can also affect the taxpayer's relationship with revenue authorities (i.e. risk rating applied by the authorities to that taxpayer) and the taxpayer's reputation could be damaged.

As a result of this, it may be in the taxpayers' best interest to consider in detail their risks in relation to general tax compliance and perform tax risk assessments across all jurisdictions where they have operations and evaluate in detail the effectiveness of existing controls over tax risks. In order to do this, it is important to understand the different types of tax risks, their sources as well as the relevant tax types impacted by those risks.

Tax risks can fall into different categories and they can arise from a number of different sources. In addition to this, most countries have various tax types and in general, there is some level of risk (i.e. possibility of a tax error) associated with each tax type. The most common taxes with inherent tax risks are discussed below. This is not a complete list of the tax types that can be found in the different countries around the world but rather an analysis of the most common tax types in the different countries. The analysis below is more generic than specific to any country, sector etc.

In summary, the following is discussed in the next sections of this chapter:

- Types of tax risks;
- Sources of tax risks; and
- Types of taxes with inherent tax risks.

2.2. Types of tax risk

There can be a number of categories of risks associated with any risk area, including tax. It is crucial to understand the types of tax risks that can be found in an organisation before analysing their source and considering / deciding on the controls that should be implemented to address the risks.

The main types of tax risks have been described by Segal and Maroun (2014:377-379) as follows:

A. **Transactional risk** - Transactional risk is a measure of the probability that unusual or complex transactions give rise to structuring commercial arrangements to avoid the payment of tax or the misapplication of tax laws (Elgood et al., 2004; Bakker & Kloosterhof, 2010; Weinberger et al., 2012). For example, routine transactions, such as purchase and sale of inventory, are likely to result in a lower transaction risk. In contrast, non-routine transactions, such as a business acquisition or a significant restructuring of an organisation, will increase the transaction-specific risk (Elgood, 2004).

   As a general rule, the higher the inherent transactional risk, the more likely tax authorities are to carry out a detailed review of the economic rationale of the transaction and its associated tax characteristics (Bakker & Kloosterhof, 2010). The operational characteristics of the taxpayer, including an established pattern of non-compliance with tax laws, are additional factors which could lead to increased scrutiny by tax authorities (Elgood, 2004)

B. **Operational risk** - 'Operational risk' is defined as 'the risk of loss resulting from inadequate or failed internal processes, people, systems or external events' (Basel II, 2006:144). Operational risk is similar to compliance risk in that it is concerned with adherence to the tax laws and decisions about the management of the final tax charge (Elgood, 2004; Bakker & Kloosterhof, 2010). Operational risk is, however, a function of the nature of the organisation, including the characteristics of its primary economic activities (part of transactional risk) and how these are managed, rather than simply a product of misapplication of tax laws. Consequently, operational risk is addressed, not simply by focusing on adherence to the letter of tax regulations, but by making use of adequate information and control systems that can provide accurate and complete information on which to base tax returns and disclosures (Stamm, 2004; Bakker & Kloosterhof, 2010). Therefore, operational risk is also affected by the extent to which an organisation makes use of a sound system of internal controls designed to provide assurance about the accuracy, completeness and validity of individual transactions.

C. **Compliance risk** - 'Compliance risk' refers to the risk of misapplication of the relevant tax laws, whether due to fraud or error (Elgood, 2004). The promulgation of new tax laws, together with the growing complexity of tax provisions, is a primary source of compliance risk (De Koker and Williams, 2011). Variations in the operational processes followed by the tax authorities can also

give rise to an elevated risk of non-compliance (Stamm, 2004). For example, the need to complete a company's tax returns correctly, to ensure that these are submitted on time, and to ascertain that the returns take cognisance of the recent amendments to tax laws are material sources of compliance risk (Stamm, 2004; Weinberger et al., 2012). This risk is, however, also a function of the operational and governance characteristics of an organisation, with the result that operational and compliance risk are interconnected and difficult to 'disentangle'.

D. **Financial accounting risk** - Effective management of transactional, compliance, and operational risk needs to be complemented by an awareness of financial accounting risk. The divergence in the treatment of transactions, events and conditions for financial reporting and tax purposes can itself pose a material source of tax risk (Elgood, 2004). Deferred tax implications (IASB, 2012) due to these differences mean that management must manage effectively not only its current tax charge, but also the future tax implications of the recovery or settlement of assets and liabilities (Elgood, 2004; Bakker & Kloosterhof, 2010; IASB, 2012). Going hand-in-hand with this is the possibility that organisations focus on the financial reporting implications of a transaction, to the detriment of prudential tax management (Mc Grail, 2011). Reinforcing the need for management of operational risk, management of financial accounting risk implies a holistic approach, where the accounting and tax implications of transactions are accorded equal importance in order to ensure tax compliance (compliance risk) and the provision of relevant and reliable tax disclosures in the financial statements (Elgood, 2004; Bakker & Kloosterhof, 2010).

E. **Portfolio risk** - is the aggregation of transactional, operational and compliance risk discussed above (Elgood, 2004; Stamm, 2004). This 'risk class' sees the organisation as a collection of different economic activities, which, individually and collectively, pose transactional, operational and compliance risks and which, in aggregate, give rise to a 'portfolio' of tax risk (consider Erasmus, 2008; Bakker & Kloosterhof, 2010). The portfolio risk of a company would, theoretically, be determined by computing a weighted average probability of each specific tax risk resulting in material financial loss and ought to be reviewed on a continuous basis (Stamm, 2004; Bakker & Kloosterhof, 2010)

F. **Management risk** - Unlike operational risk, management risk is not an assessment of tax risks arising at transactional or operational levels, but rather about a culture of comprehensive TRM (Weinberger et al., 2012). Management risk will be inversely related to the extent to which an organisation relies on the review of tax practice at senior levels and places the economic reality of transactions ahead of the need to achieve a predetermined tax outcome. In line with the recommendations of the IRC (2011), management risk would also be mitigated by developing a clear strategy for dealing with tax authorities and defining the organisation's appetite for tax avoidance. This necessitates not only a sense of business ethics when it comes to tax, but also the use of appropriately qualified staff at senior levels to ensure effective monitoring and review of tax-related issues in the company's control environment (Erle, 2006; Weinberger et al., 2012).

G. **Reputational risk** - Reputational risk is concerned with the tax practices of an organisation posing a threat to its credibility as a legitimate institution (Elgood, 2004). For example, if aggressive tax practices become public, an organisation may be perceived as conducting its business recklessly, without regard for the importance of fair and sustainable practices that are mindful of the interests of a broad group of stakeholders (Stamm, 2004; Bakker & Kloosterhof, 2010). In extreme situations, a perceived inconsistency between an organisation's tax policies and a generally accepted view that one ought to pay a fair share of the profits generated to the fiscus (Vivian, 2006) can pose significant threats to an organisation's longevity. This is especially true in the context of the global financial crisis, which has seen many companies, such as Starbucks and Amazon, come under increased public scrutiny for allegations of tax practices that are inconsistent with the ideals of contributing sustainably to the relevant jurisdictions in which they operate (Weinberger et al., 2012).

The above summary gives an overview of the different types of tax risks that may be found in an organisation. In trying to get a better understanding of these tax risks and how they can be managed effectively, it is important to also understand their source / triggers, these are discussed in the next section.

2.3. Sources of tax risk

Some taxpayers may be seen as being reactive to tax risks or tax problems rather than investing time and resources into identifying the root cause of the risks and implementing controls to manage the risks.

Recent corporate scandals such as Enron, WorldCom etc. have shaped a new standard on corporate governance, thereby raising public expectations on how firms manage their various risks, including tax risk. (Neubig and Sangha, 2004:116)

In order for an organisation to effectively manage its tax risks, it is crucial to understand the causes / sources of the risks. Tax risks can arise from various sources and not only from an incorrect analysis of the technical facts. These potential sources of risk or other causes for errors or potential sources of risk should also be considered (Bakker & Kloosterhof, 2010:41).

According to Elgood et al. (2004:34) the main sources of tax risks are changes in the business and the on-going day-to-day activities.

According to Deloitte United States of America (2011), the main sources of tax risks are as follows:

- Business units
- Systems
- Processes
- People
- Governance

Different factors can trigger tax risks. The tables below set out, at a high level, some of the potential causes that need to be considered in an attempt to adequately understand tax risks.

Table 1: Various risk sources (underlying causes) that can make any tax position risky include, but are not limited to the following:

Type of tax risk	**Source / Cause**
Compliance or operational risk	• Occurs because of non-compliance with tax requirements factually, or lapsing over time, thereby jeopardizing the viability of a tax position (e.g. tax elections that must be made at a particular time or in a particular matter to be effective).
Economic and business assumption risk	• May change the premise on which many tax positions are based, such as revenue and net income growth expectations, which if not realized make the tax position worthless or significantly reduced in value.
Financial risk	• May manifest itself through adverse interest rate, currency, or market movements that interact with tax positions to make their outcome uncertain.
Legal risk	• Owing to uncertainty in the outcome from the judicial process may undermine the presumed value of tax positions. This risk includes judicial risk in tax controversy and non-tax issues such as contractual or corporate matters.
Legislative risk	• Occurs because of potential changes in current law that may erode the value of current and past tax positions.
Regulatory risk	• Emerges from increased intensity of audits and review by taxation authorities or other industry regulators that may challenge the validity of a company's tax positions, which can impose a cost even if the outcome is ultimately favourable to the taxpayer.
Segmented strategy risk	• Results from situations where various stakeholders create tax positions without clear coordination with the tax department. For example, the human resource department may incur tax risk indirectly through changes to pension plans and stock options without sufficient communication with the tax department.

Tax technical risk	• What most people view as tax risk emanating primarily from the potential uncertainty in the interpretation of tax laws by tax authorities. Companies often receive opinions about the tax technical risk of particular tax positions (e.g. a “should” opinion suggests a 70 - to 80 - percent likelihood of prevailing on the merit in litigation). Even with the highest “should” opinion, the 20 - to 30 - percent likelihood of losing the position involves technical and regulatory risks of unwinding the transaction or paying penalties.

Source: Adapted from Neubig and Sangha (2004:114)

Table 2: The Deloitte Tax Value Map to assess tax risks and opportunities in SA

Type of tax risk	Risk category	Source/ Cause
Governance	Corporate Governance	• Lack of a formalised tax risk policy document resulting in poorly defined processes and procedures • Lack of formalised tax steering committee • Lack of ownership of tax responsibilities / functions • Lack of appropriate incentives offered for tax effectiveness and efficiency for senior management across the business • Key performance indicators based on pre-tax profits resulting in lack of rigor around tax effectiveness • Lack of tax representation on the Board of Directors / Audit Committee • Inability of Group Tax to effectively leverage internal audit function • Failure to elevate tax issues adequately / timeously within organisation • Failure to inform tax department of activity requiring their attention • Poor internal communication – operational management not aware of possible tax savings, exposures or tax staff not aware of accounting developments etc. • Inadequate review or monitoring of tax function • Inadequate or overly excessive conservative / aggressive tax planning • Failure to adequately spread group tax history / knowledge • Over-reliance on key tax staff and lack of succession planning / inadequate handover procedures

		• Failure to consult at the right level on tax matters – internally and externally • Inadequate integration between tax and finance functions • Inadequate control of tax management in off-shore subsidiaries resulting in errors and losses
	Ethics	• Inappropriately aggressive tax positions resulting in negative publicity and damage to reputation • Inadequate internal communication of tax risk appetite • Lack of adequate tax compliance policies and procedures • Failure to take adequate corrective and / or disciplinary action in cases of non-compliance • Lack of defined protocols to address tax disputes • Inappropriate reliance on tax practitioners whose tax risk profile is too high / low
Strategy and Planning	Corporate Responsibility and Sustainability	• Negative public and internal perceptions due to aggressive tax planning / poor compliance • Inadequate planning for carbon tax • Poor understanding of sustainability and the associated tax implications • Failure to obtain available tax benefits for Public Benefit Activities • Lack of understanding of the Income Tax, Value-Added Tax and incentives implications of corporate responsibility initiatives. • Exposure to reputational damage due to focus by authorities on base erosion and profit shifting
	External Factors	• Lack of understanding of the tax and regulatory challenges / constraints in each country • Lack of formalised process and assignment of responsibility to analyse impact of tax policy / legislation changes across all jurisdictions

		• Failure to respond adequately to changes in tax policy legislation across all jurisdictions • Lack of consideration given to political risks, for example, restrictions on transfer of funds out of the country • Lack of consideration of Black Economic Empowerment ("BEE") / minority shareholders' impact on funding options, resulting in negative tax implications
	Planning	• Failure to integrate tax risks / opportunities into business planning process • Inadequate tax planning resulting in lost tax savings, for example, Incentives, Research and Development, education trusts and Public Benefit Organisations status, Transfer Pricing • Failure to focus tax department on pro-active tax planning • Incorrect and incomplete implementation of tax planning • Inaccurate tax forecasts due to the use of management reports not split by taxable entity • Inadequate involvement of tax expertise in contracting process • Negative tax and other cost implications due to sub – optimal group structure • Failure to plan holistically for taxes on cross-border transactions • Failure to lobby on dumping tariffs and other rebate provisions • Failure to plan for on-going international assignment of staff • Failure to participate in the South African Revenue Service ("SARS") Preferred Trader Programme • Inability to obtain tax clearance certificate timeously

		• Failure to consider exchange control implications of transactions • Failure to maximise duty benefits e.g. preferential trade agreements, rebates and refunds • Failure to consider reportable arrangements and General Anti-Avoidance Rules (GAAR) • Failure to test restructuring by reference to balance sheet data • Failure to use implementation checklists in complex transactions • Lack of process to deal with a visit from SARS personnel • Failure to make timeous use of voluntary disclosure programme on key tax risks • Failure to make use of SARS ruling application system on material transactions
	Strategy	• Failure to consider the tax risks / challenges / opportunities associated with corporate strategy • Failure to integrate tax strategy across all business units and regions • Failure to fully understand the tax implications of multi jurisdiction group structures • Inability to manage high effective tax rate in comparison to peers – excessive withholding taxes • Failure to capitalise on global tax incentives during global project planning • Failure to consider exit strategies for foreign and local acquisitions upfront • Insufficient tax screening of targets • Inadvertent tax consequences resulting from complex Mergers and Acquisitions (M & A) transaction (restructure, acquisition, disposal) • Lack of representation on industry specific tax committees

		• Failure to consider opportunity to lobby for incentives • Failure to integrate global staff mobility with talent and tax strategies • Failure to address expat tax issues prior to entering foreign markets • Failure to consider the tax consequences of selling goods and services online
	Group Structure	• Cumbersome / fragmented / complex group structure resulting in tax costs and other inefficiencies e.g. non-utilisation of tax losses, increased VAT costs or insufficient funding • Failure to fully manage changes in group structure, registrations, company names and public officer • Failure to optimise registration for various taxes across the group • Failure to register separate activities for VAT purposes e.g. partnerships, joint ventures etc. • Failure to clean up dormant companies / deregister for all taxes prior to deregistration • Failure to align legal / reporting / management / tax structure • Financial reporting lines exclude tax function from critical information • Failure to adequately address deductibility of interest on inbound intragroup financing and transfer pricing on cross border group transactions • Failure to properly apportion VAT input tax and expenditure for income tax in holding company and other appropriate instances • Failure to synchronise cash flows with tax effects • Inefficient / inappropriate pricing of goods / services between group companies from a tax point of view

		• Lack of adequate foreign in-country tax legislation review • Inaccurate Controlled Foreign Company ("CFC") calculations • Lack of consideration of Double Tax Agreements network • Inadvertent creation of CFC's and permanent establishments in foreign jurisdiction • Lack of consideration of withholding tax on dividends, interest and royalties • Inadequate attention to effective management considerations and tax residency issues • Lack of use of immediate holding company / headquarter company / foreign investment entity / domestic treasury management company concept • Failure to consider effectiveness of global / regional employment company • Failure to register foreign activities for VAT purposes, in SA and / or foreign jurisdiction • Lack of understanding by foreign stakeholders of the in country tax challenges
Operations/ Infrastructure	Corporate Assets	• Failure to correctly identify / categorise tax depreciable assets • Suboptimal tax depreciation policy • Discrepancy between financial and tax information relating to fixed assets • Failure to track base costs of assets • Failure to execute asset transfers e.g. immovable property, intellectual property • Incorrect treatment of sale of capital assets for Income Tax / Capital Gains tax • Failure to utilise tax effective corporate structure / location of ownership of intangible assets • Lack of proper intellectual property register

		• Failure to utilise incentives / grants available for capital investment • Inappropriate tax treatment of finance leases e.g. VAT treatment and ring fencing • Incorrect tax valuation of financial instruments and derivative positions • Failure to consider Customs implications of Capex decisions • Failure to address Transfer Pricing on the use of intellectual property by foreign connected persons • Incorrect VAT treatment of intangible assets
	Finance	• Failure to address tax risks in funding decisions e.g. dividends taxed as interest, debt treated as equity • Failure to adequately address deductibility of unproductive interest and excessive interest • Incorrect treatment of VAT issues relating to funding e.g. bond issues, share issue • Failure to benefit from tax deductibility on loans taken out for share acquisitions • Failure to address the risk relating to stock lending and equity repo transactions e.g. dividends treated as taxable • Failure to make use of shared service centres for tax compliance • Inadequate or overly aggressive tax planning • Lack of tax expert involvement in unusual / non-standard transactions • Ineffective tax audit management • Inability to meet cash tax obligations • Failure to use accelerated tax dispute resolution techniques • Failure to receive timeous tax refunds • Inadequate / out of date transfer pricing policies • Noncompliance with transfer pricing requirements

		• Incorrect valuation of imported / exported goods • Failure to zero-rate VAT / Customs duty on goods to be exported • Failure to adjust Customs and VAT for retro-active transfer pricing adjustments • Incorrect tax treatment of International Financial Reporting Standards (“IFRS”) adjustments • Incorrect tax treatment of foreign exchange gains and losses • Incorrect tax treatment of securitisation vehicles • Incorrect treatment of investment policies e.g. cell captive arrangements • Poor audit quality resulting in forfeited grants and incentives • Lack of full understanding of local tax incentives • Loss of research and development incentives due to use of sub-contractor
	Human Resources	• Lack of adequate tax expertise / resources across business • Tax department lacks up to date knowledge across all tax types • Inadequate key performance indicators for tax staff • Lack of relevant tax training for all staff across the business • Lack of formalised multi jurisdiction tax update process • Lack of training of payroll staff resulting in Pay-As-You-Earn (“PAYE”) non-compliance • Lack of training of capture clerks could lead to incorrect tax data classification and VAT treatment • Inadvertent creation of foreign permanent establishment through uncontrolled deployment of staff on foreign assignments • Failure to provide adequately for relocation of mobile employees

		• Expatriate issues not adequately controlled • Expatriate taxes managed by Human Resources ("HR") without tax department input • Inappropriate reliance on outsourced payroll provider • Incorrect tax treatment of contractors • Failure to claim incentives for learnerships / training and development • Failure to optimise share incentive schemes / bonus structure for tax purposes • Failure to adequately address VAT on fringe benefits • Failure to levy VAT on salary recharges
	Legal	• Contracts are not routinely reviewed by the tax department • Lack of consideration of tax consequences caused by contractual arrangements • Inadequate / lack of tax protection, indemnities / warranties in M & A transactions • Inadequate attention to going concern clauses in sale / purchase of business agreements • Inappropriate allocation or discharge of purchase price • Failure to create transaction master files • Lack of alignment of agreements, resolutions and recordals • Lack of proper contract register • Lack of consideration of agent / principal issues for VAT, Customs, Transfer Pricing and permanent establishment purposes • No process to track and monitor government gazettes • Failure to obtain exchange control approval for foreign share schemes

	Information Technology	• Inadequate tax expert consideration / representation in design of Enterprise Resource Planning ("ERP") systems / key Information Technology ("IT") decisions • Failure to adjust tax input processes when new IT systems are implemented • Errors in ERP system configurations • Inability of the ERP system to facilitate capture of necessary tax information (in particular on fixed assets and VAT inputs) • Inability to capture required tax and legal data at operational level • Failure to align IT systems with tax reporting requirements (such as the SARS IT14SD) • Lack of integration of tax systems in broad IT infrastructure • Inaccurate and incomplete tax data • Tax computations not sufficiently automated • Lack of technology skill / understanding / use of technology by tax department • Inadequate controls over tax spreadsheets • Failure to use technology to automate tax compliance controls • Use of Excel to populate sophisticated and complex returns for submission to SARS, for example, Excise and Valorem • Disconnect between transaction accounting and operational product movement especially relevant in excise industries • Inability of systems to track research and development information required for tax incentive • Failure to comply with tax requirement for record management / retention

	Sales, Marketing and Communications	• Lack of tax expert review of marketing documentation • Inadequate communication of tax risk policy to stakeholders • Lack of understanding of tax communications and policies by employees • Failure to consider VAT risks e.g. transactions for no consideration, donations, charitable activities, barter arrangements and entertainment • Failure to consider permanent establishment / source issues in foreign jurisdictions • Lack of consideration of incentives e.g. call centre incentives, R & D incentives
	Supply Chain	• Supply chain not optimised from tax perspective • Inappropriate reliance on customs clearing agents • Failure to consider such as whether trade agreements exist with countries where goods are sourced • Lack of consideration of VAT issues on imports of goods and services • Failure to consider transfer pricing exposures • Lack of consideration of withholding taxes • Inadequate controls over warehouse / bond stores • Lack of understanding of risks and impact of incoterms • Failure to consider use of industrial development zone
	Product Development	• Failure to consider tax treatment of new products in pricing decisions • Failure to consider customs and other tax implications of taking products into new markets • Sub-optimal tax arrangement for the development of intellectual property e.g. transfer pricing considerations

		• Failure to charge arms-length price for inter-company research and development • Failure to address intellectual property originating location issues • Failure to claim tax incentives for research and development
Compliance	Compliance	• Failure to meet filing deadlines due to inadequate tax planning / controls or inadequate resources • Lack of adequate group wide due date tracking technology • Inability to provide executive dashboard of tax compliance status across group • Lack of global tax compliance tools • Poor relationships with tax authorities as a result of poor compliance • Inability to obtain tax clearance certificate due to non-compliance • Lack of standardized compliance procedures / policies • Lack of adequate review and monitoring processes in compliance functions • Lack of dedicated compliance staff • Failure to assign clear compliance roles, responsibilities and accountability • Failure to establish accountability and measurement or monitoring of tax compliance • Failure to discipline incidents on non-compliance • Failure to provide tax compliance training • Failure to implement procedures to respond to revenue queries / disputes • Inadequate early warning systems • Challenges in managing in country tax compliance and ensuring deadlines are achieved across all jurisdictions

		• Incorrect provisional tax calculations resulting in unnecessary penalties and / interest • Lack of timeous communication of legislation amendments resulting in compliance issues • Incorrect interpretation / implementation of tax legislation • Lack of knowledge, resources or processes in foreign jurisdictions • Failure to notify SARS of changes in address / representative person • Failure to apply for deferral of payment on matters under objection • Use of old / incorrect registrations • Internal audit procedures not defined or enforced for tax related issues • Lack of sufficient audit trail to support tax calculation • Failure to comply with tax requirements for record management and retention • Inadequate tax data for compliance purposes • Poor management of tax documentation • Incomplete/insufficient for exports / imports • Lack of supporting documentation for inter-company charges • Failure to maintain adequate documentation for claiming of tax credits across jurisdictions • Failure to maintain accurate transfer pricing documentation and correctly implement policy • Loss of donation deductions due to lack of S18A certificates • Lack of adequate VAT, Customs and PAYE reconciliations, specifically in light of IT14SD requirements • Failure to adjust VAT processes for rulings that have been withdrawn

		• Inability to monitor VAT refunds • Incorrectly calculated tax recovered from customers, for example, insurance policy holders of long term insurer • Lack of adequate controls regarding the use of bond stores and rebate facilities • Lack of up to date Value Determination with SARS for related party imports • Incorrect classification / valuation of imported goods • Lack of timeous approvals by South African Reserve Bank • Transgression of exchange control regulations • Lack of compliance with Foreign Account Tax Compliance Act • Lack of compliance with Department of Trade Industry regulations relating to incentives etc. • Failure to comply with immigration regulations • Failure to declare transfer pricing adjustments on annual tax returns
Reporting	Reporting	• Inaccurate / incomplete tax disclosure in the annual financial statements • Lack of global tax reporting capacity • Inability to implement IFRS relating to tax • Inadequate tax sensitization of financial data • Inadequate / excessive global tax provision evaluation • Failure to align with local and international reporting requirements e.g. solvency II, Base III • Failure to adequately document significant tax positions • Failure to raise group tax provisions for uncertain tax positions • Tax reporting negatively impacted by tight financial reporting deadlines and late adjustments

		• Inability to track tax forecasts / short-term targets • Failure to align management reporting on business line / regional basis with taxable entities • Inability to produce tax basis balance sheets • Inadequate reporting of CFC information • Failure to disclose reportable arrangements to revenue authorities • Inability to produce certificates / proof of foreign taxes • Failure to receive SARS correspondence from e-filing as a result of incorrect notification settings on e-filing • Inability to comply IT14SD reporting requirements

Source: Adapted with minor changes from Deloitte South Africa (2016)

Table 3: Events of tax risks

Type of tax risk	Typical events giving rise to tax risk
Transactional	Acquisitions
	Disposals
	Mergers
	Financing transactions
	Tax driven cross border transactions
	Internal reorganisations
Operational	New business ventures
	New operating models
	Operating in new locations
	New operating structures (e.g. JVs / partnerships)
	Impact of technological developments (e.g. internet trading)
Compliance	Lack of proper management
	Weak accounting records or controls
	Data integrity issues
	Insufficient resources
	Systems changes
	Legislative changes
	Revenue investigations
	Specific local in country customs, approaches and focuses in compliance
Financial accounting	Changes in legislation
	Changes in accounting systems
	Changes in accounting policies and GAAP
Portfolio	A combination of any of these events
Management	Changes in personnel – both in tax and in the Business
	Experienced tax people leaving – and information being in their heads and not properly documented
	New / inexperienced resources
Reputational	Revenue authority raid / investigation
	Press comment

	Court hearings / legal actions
	Political developments

Source: Adapted from Elgood et al. (2004:35)

2.4. Types of taxes

Taxes can be complex and in many countries, there are various taxes that an organisation may be liable for or be liable to collect on behalf of the revenue authorities. It is important to distinguish between the different tax types as some may present more tax risks than others.

Most businesses are subject to a variety of taxes and for some businesses, this may also be across various jurisdictions. Tax systems in the various jurisdictions may be different, the Organisation for Economic Co-operation and Development ("OECD") has however provided guidance on the different types of taxes that may be applicable in the different jurisdictions.

The below is not a comprehensive list of all taxes in the different jurisdictions but only a summary of the most common tax types.

1) Income Tax

According to the OECD (2016:327) income tax covers taxes levied on the net / taxable income or profits (i.e. gross income minus allowable expenses and relevant rebates) of individuals and enterprises.

2) Value-Added Tax / Sales Tax

Value-added tax general consumption taxes charged on value-added, irrespective of the method of deduction and the stages at which the taxes are levied. In most jurisdiction, immediate deduction of taxes on purchases is allowed throughout the supply chain as the tax is imposed at all stages. The final consumer however bears the cost of the taxes paid on the purchase as no deduction is allowed for the party 'consuming' the goods or services and not on-supplying such. (OECD 2016:332)

Sales tax covers all general taxes levied at one stage only; either at the manufacturing stage or production stage, wholesale stage or retail stage. The taxes levied at either of these stages are classified here. (OECD 2016:333)

3) Customs Duties

Customs duties cover the taxes, stamp duties and surcharges imposed by law on imported goods. This however does not cover taxes collected on imports as part of a general tax on goods and services e.g. value added tax, or an excise duty applicable to both imported goods and domestically produced goods. (OECD 2016:334)

4) Excise Duties

Excise duties cover taxes levied on particular products, or on a limited range of products and may be imposed at any stage of production or distribution. These are usually assessed by reference to the weight or strength or quantity of the product and sometimes assessed by reference to the value of the product. (OECD 2016:333)

5) Capital Gains Tax

Capital gains tax covers taxes imposed on capital gains. These taxes can be levied on the gains of individuals and / or on the gains of corporate enterprises. In most instances, this applies to capital gains resulting from the sale of a property. (OECD 2016:328)

6) Payroll Taxes

Payroll taxes cover taxes paid by employers, employees or the self-employed either as a proportion of payroll or as a fixed amount per person. These payments do not give entitlement to social benefits. (OECD 2016:330)

7) Property tax

Property tax typically includes taxes on the use, ownership or transfer of property. These include taxes on immovable property or net wealth, taxes on the change of ownership of property through inheritance or gift as well as taxes on financial and capital transactions. [OECD Page 330]

It is important for businesses to carefully analyse the different taxes applicable to them, also taking into account all the jurisdictions where they operate and the taxes that may be applicable to them in those jurisdictions, to ensure general compliance with the tax

requirements in respect of all tax types and jurisdictions. This will also help them to ensure that tax controls are in place and working effectively to mitigate any potential tax risks.

Now that the types of tax risks, the sources of tax risks and the types of taxes with inherent tax risks have been discussed, the process to manage the tax risks is considered in the next chapter.

3. CHAPTER 3: TAX RISK MANAGEMENT PROCESS

3.1. Tax risk management overview

Tax risk management is about understanding where the tax risks arise and making judgement calls as to how they are dealt with. (Elgood et al., 2004:3)

Understanding where tax risks arise has been addressed above, making judgement calls as to how they are dealt with should also be considered. When tax risks are identified in a business, it is highly likely that recommendations will be sought to address the historic impact as well as the future impact of those risks. These recommendations can be used to make judgement calls on how the risks are dealt with. The process of identifying the tax risks, gathering recommendations and implementing them may differ from organisation to organisation. In some businesses, the risks identified may be recorded in a tax risk register and the process to be followed to mitigate the risks documented in the register. This however may not be not necessarily be the case for other businesses.

Vodafone is one of the few businesses that have a tax risk management strategy document available in the public domain (Vodafone, n.d). It is therefore only an expectation that large corporates will have a documented tax risk management strategy as this is not a requirement in terms of the legislation in various countries (van der Walt, 2015). This raises the question on what information is used by most organisations to make judgment calls as to how tax risks will be dealt with.

When an organisation documents tax risks, recommendations and / or tax strategy, tax risks which cannot be completely avoided can be mitigated or managed. It is important that risk management and controls are not seen as a burden on business, but rather the means by which business opportunities are maximised and potential losses associated with unwanted events reduced (Stock, 1999:14).

Identifying the benefits of tax risk management as part of overall risk management may help change the perception of tax risk management from being a burden to an opportunity of preventing a waste of resources e.g. finances, employees' time etc., which could be used in future to advance the business.

Historically, tax risk management and tax internal controls were not necessarily understood by the tax function and those outside the tax function. This seems to be changing as tax risk management is now being discussed inside both commercial organisations and revenue authorities. Organisations are starting to document their tax risk management policies and to do this they have to assess the different types of tax risk in their business. Some organisations have also recently appointed internal tax risk managers. (Elgood et al., 2004:2)

Good corporate governance codes require the board to install a system of risk management. According to van der Walt (2015); globally, revenue authorities have signalled their expectation that large corporates will strengthen their corporate governance in the area of tax risk management. It is possible to manage tax risk in a global business environment by using leading practices that address both the needs of business and the expectations of tax administrators. The goal is to achieve a level of certainty about tax positions, tax reporting and tax planning that aligns with the principles of good corporate governance and that will satisfy the concerns of both parties. An interesting point is made, namely that tax risk management should not be undertaken purely to satisfy the expectations of revenue authorities but also because tax risk management could bring competitive advantages. Another point made is that, those that succeed incorporate tax risk management into the core of their business decisions – from the boardroom and audit committee agendas to the operations on the ground in various tax jurisdictions.

3.1.1. Stakeholders involved in managing tax risks

There are (or should be) many stakeholders, both inside and outside the organisation, involved in managing risk, and in particular managing tax risk. The first point therefore is to consider who, in addition to the tax function, are the stakeholders in a business's tax risk management. (Elgood et al., 2004:11)

Tax risk management as described above is a process involving understanding where the tax risks arise and making judgement calls as to how they are dealt with. The tax function or the auditors (internal or external) of the organisation would be best placed to review the organisations tax affairs to identify tax risks and making judgement calls as to how the risks are dealt with. The revenue authorities however, may also undertake a tax review / audit to identify tax risks or non-compliance. Although both a review by the tax function or auditors and the revenue authorities have a similar objective, which is to identify tax risks, the outcome of the reviews have different consequences.

A review by the tax function or the auditors can be used as an opportunity to mitigate historic and future risks whereas a review by the revenue authorities could mean that the business has missed the opportunity to identify and mitigate the risks before they have a financial impact.

Where a careful review of taxes is performed internally without involvement from the revenue authorities, the different business units can be involved as they have a deeper understanding of the day-to-day activities or operations that give rise to tax risks. Risks identified with this level of information can be used to make judgement calls on how the risks are dealt with, also taking into consideration the commercial realities and the impact of any tax decisions as a whole. The CFO / CEO and the board would consider the findings of such reviews useful in the decision making process. This could also be useful to audit committees, risk committees or investors.

In deciding how tax risks are dealt with, internal controls are usually recommended to mitigate the risks. Implementing and testing internal controls is often considered as a function to be performed by the internal auditors. The question then becomes, who is the right person to recommend the internal controls to be implemented? A collaboration between all the stakeholders in tax risk management would be best as they all bring a different dimension or perspective on the risks identified as well as how those risks can be addressed from a practical perspective.

The tax risk management framework is not only for companies with enough resources like tax managers, but also can be applied to organisations of all types and sizes. Different parties can be stakeholders in the tax risk management process as they have an interest in an organisation’s tax affairs (Elgood et al. 2004:11).

Diagram 1: the different parties who have an interest in an organisation's tax risk management

Source: Adapted from Elgood et al. (2004:11).

3.1.2. The Tax Risk Management Control Framework

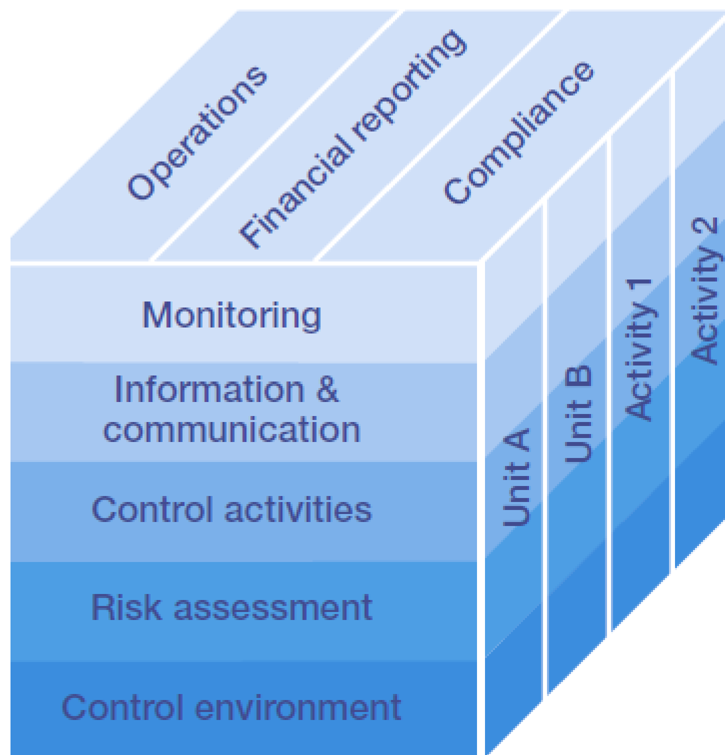
The Committee of Sponsoring Organisations of the Treadway Commission (COSO) facilitated a study to develop a general framework for internal control. This has resulted in the widely recognised and leading international standard for an integrated framework of internal control, which is known as the COSO Framework (Elgood et al., 2004:20).

According to Elgood et al (2004:20), the COSO Framework defines internal control as:

> A process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
>
> - Effectiveness and efficiency of operations;
> - Reliability of financial reporting; and
> - Compliance with applicable laws and regulations.

The role of internal controls is to manage risks rather than to eliminate them (Stock, 1999:14]. As the COSO Framework is the widely known, as well as the leading model for internal control - and is being used on a global basis, it appears to be the appropriate model to consider for tax risk management (Elgood et al, 2004:20).

Diagram 2: The COSO Framework representation



Source: Adapted from Elgood et al. (2004:22).

The above COSO Framework sets out the five interrelated components in an integrated system of internal control that applies to organisations of all types and sizes – and hence should equally apply to tax risk management. The five components are:

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring

Communication is relevant to all five components in the COSO framework.
Local subsidiaries need to have some understanding of the group's tax risk policy and the control environment within which the group is working. The head of tax needs to understand where the local risks lie so that they can help put control activities in place and also find a way of monitoring these activities. (Elgood et al. 2004: 51)

A tax control framework should result in an effective, efficient and transparent tax function. In setting up a Tax Control Framework, an organisation should make clear decisions as to what the scope will be. Firstly, the organisation should decide which taxes could potentially have a material impact on the organisation. When measuring this impact, an organisation should not only look at the direct financial impact but should also look at other potential impacts such as impact on reputation. For most organisations, this will mean that corporate income tax, value-added tax and taxes on wages are relevant or 'in scope'. (Bakker and Kloosterhof, 2010:24).

3.2. The role of the tax function in tax risk management

The tax function has the responsibility of managing most of the tax compliance requirements or outputs and the activities, events or transactions that create tax risks. In addition to this, the tax function is the primary role player in tax risk management.

It is thus important to understand the tax function or the head of tax's role in relation to tax risk management. It is also important to understand how these roles on tax risk management fit in with the objectives set out in the organisation's overall risk management plan.

The head of tax usually has prime responsibility for the management of risk – ensuring that the right people are in place to manage tax, ensuring these people have the right skills, and ensuring that the appropriate processes and procedures are in place (Elgood et al, 2004:14).

By ensuring that the right people are in place to manage tax, this will ensure that the tax team is able to identify potential tax risks and their sources in the day-to-day activities of the business including new transactions before they are concluded or before any agreements are concluded.

In addition to the above, the head of tax sets the tone on tax risk management for the rest of the organisation – whether it is the tax team doing the tax returns or the advice and support provided to operational and other teams doing their jobs (Elgood et al, 2004:14).

The tax team / function is usually made up of tax experts. These experts can offer insights with valuable knowledge based on their experience when trying to understand the sources of tax risks and deciding on ways to deal with the risks. However, dealing with risks usually involves implementing internal controls; can the tax experts express a view on the internal controls over tax? Providing assurance on the internal controls over tax is the role of internal auditors (IIA, n.d).

The tax risk management policy of an organisation should be prepared by the tax function after consultation with the relevant stakeholders discussed under 3.1.1. This will help the tax function to ensure that appropriate processes and procedures are in place. The policy should also provide guidance on who should take responsibility should revenue authorities take different tax positions to those adopted by the organisation or should they adjust the tax figures declared by the organisation. The review process wherein a view on the effectiveness of the internal controls is expressed should also be documented.

In some businesses, there may not be a specialised tax function and the finance department may be responsible for tax risk management. In other businesses, the tax function may be very lean or the finance department may not be experienced enough in tax that the tax function has to be outsourced to consultants.

In this case, it is extremely important that the tax risk management policy is prepared with adequate support from the relevant stakeholders, as this will also clarify the role to be played as well as the processes and procedures to be followed by whoever is tasked with the responsibilities or function.

3.3. The role of the internal audit function in tax risk management

The internal audit function has a significant role to play in tax risk management. Generally, internal auditors are tasked with assessing risk, planning how the risk will be audited and considering the controls to be implemented to mitigate the risks. In order to meet their objectives, internal auditors need to understand the organisation’s position on tax risk. This includes the tax processes and procedures to be followed. This is applicable to any role they may be tasked with, either in relation to monitoring controls or in relation to reviewing the tax function. (Elgood et al, 2004:14)

Internal auditors may find the tax function as one of the more difficult areas to review as it is largely based on legal principles and that may be considered too specialised (Elgood et al, 2004:14). This can lead to internal auditors steering away from reviewing tax risks and controls due to the lack of experience in assessing tax risks, recommending internal controls over tax as well as assessing the effectiveness of any internal controls that may be in place.

Where the internal audit function performs a detailed review of the tax risks, they can help raise the profile of the tax function by highlighting where the tax function is adding value to the business (Elgood et al, 2004:14). Similarly, the tax function can help raise the profile of the internal audit function where the value-added by the internal audit function through the detailed review can be highlighted. This suggests that both functions have a significant role to play in the tax risk management process.

In an organisation’s governance structure, the internal audit department has an important role to play; which is ensuring that the organisation has a tax control framework in place. The internal auditors will not audit the tax technical content of the tax position of the organisation, but can audit whether appropriate persons were involved as set out in the tax control framework. As a result, the internal audit function plays a vital role in the operation of a tax control framework (Bakker & Kloosterhof, 2010).

The role of internal audit is evolving to being a key driver in maturing the tax processes and operations and not just including proper control procedures (Bennecke and Lau, 2012:13). Due to the evolution of the role, the internal audits performed can add value to organisations. The internal audit activity adds value to the organization (and its stakeholders) when it provides objective and relevant assurance, and contributes to the effectiveness and efficiency of governance, risk management, and control processes. (King IV)

The following principles from King IV would assist executive management to promote the internal audit activity’s role of adding value to the organization.

Principle 5.1:

- The Board should ensure that there is an effective risk based internal audit.
- Internal audit should have the following key responsibilities: Performing an objective assessment of the adequacy and effectiveness of risk management.

Principle 5.4:

- Internal audit should follow a risk-based approach in its plan.
- As a start the IIA standards for internal auditors states that internal auditors must have regard to key risks and that:

> The internal auditors should be alert to the significant risks that might affect objectives, operations, or resources. However assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified.

It is clear from the above that while the responsibility for identifying and managing risks belongs to management, one of the key roles of internal audit is to provide assurance that those risks have been properly managed.

Since management has the responsibility to manage risks, it can leverage off the tax function to identıfy the risks and rely on both the tax and internal audit functions to recommend internal controls to mitigate those risks. Internal audit can therefore, through testing provide assurance that the risks will be addressed by the controls. According to principles 5.1 and 5.4 (King IV), this testing should be done on a risk based approach.

The IIA defines risk based internal auditing as a methodology that links internal auditing to an organisation's overall risk management framework. Risk based internal auditing allows internal audit to provide assurance to the board that risk management processes are managing risks effectively, in relation to the risk appetite. (IIA, 2016)

4. CHAPTER 4: INTERNAL AUDIT PROCESS

4.1. Internal audit overview

The IIA (n.d.) define the primary role of the internal audit function as providing reasonable assurance to executive management and the Board about the adequacy and effectiveness of the risk management control framework in operation. The secondary role is to strengthen and improve the risk management and control framework through the promulgation of best practice.

> Internal Auditing is an independent and objective assurance and consulting activity that is guided by a philosophy of adding value to improve the operations of the organisation. It assists the organisation in accomplishing its objectives by bringing a systematic and disciplined approach to evaluate and improve the effectiveness of the organization's governance, risk management and internal control. (IIA, n.d)

According to the IIA (n.d) every internal audit engagement is unique; however, the process of internal auditing is similar for most engagements and normally consists of four stages. The process of internal auditing over tax will therefore also be different, however, the general process of an internal audit is set out below and it briefly explains what happens during each stage and outlines the questions and actions the internal auditors need to address for completion.

A. Research

Before an internal audit starts, the internal auditors need to gather information about the subject area or activity they are about to review, for example, tax. The information gathered can include, *inter alia*, the following:

- What are the objectives?
- What activities occur?
- How are they performed?
- How is performance measured?
- What are the risks (current, emerging, horizon)?
- What are the responses to risks?
- How do managers know responses to risks are effective?

B. Planning

After completing the research, the internal auditors can plan the audit. Planning can be done using their analysis of the information gathered through the research referred to above. In the planning phase, the scope and objective of the audit is determined and agreed with the audit manager and the managers in the organisation. The planning phase typically involves the following:

- Determining the scope of the audit;
- Establishing and agreeing audit objectives and the criteria to be used;
- Obtaining resources with appropriate skills, knowledge and experience;
- Setting targets, outputs and deadlines;
- Preparing a timetable and schedule events; and
- Preparing a programme of work.

C. Providing assurance

During the internal audit, the internal auditors collect information and make observations. Based on this, they communicate if things are working effectively. The information and observations can be collected or made in any of the following ways:

- Gather information through discussions, interviews, observations and other internal audit tests;
- Analyse and evaluate information against criteria;
- Document / evidence findings;
- Draw conclusions and form opinions; and
- Communicate results.

D. Action

As part of the assurance activities carried out by the internal auditors as set out above, managers acknowledge the risks identified and report it up the line or agree to implement improvements. The internal audit is not over until the reporting of the changes takes place. The following actions are usually taken at this stage:

- Agree with managers what actions they will take;
- Clear responsibility and target dates are set; and
- Ensure process to follow up actions is in place.

Now that an overview of what an internal audit entails has been discussed, the roles to be played by the internal audit function as well as the tax function will now be considered.

4.2. The role of the internal audit function in the internal audit process

The internal audit function can either be an in house function or it can be out sourced to external consultants. Regardless of who performs this role, the purpose or objective should be the same as internal audit professionals in most countries are guided by the standards issued by the IIA.

The scope of internal auditing is found in the Institute of Internal Auditors' Performance Standard 2110.A2 (Pickett, 2010) which states that: the internal audit activity should evaluate risk exposures relating to the organization's governance, operations and information systems regarding the:

- Reliability and integrity of financial and operational information;
- Effectiveness and efficiency of operations;
- Safeguarding of assets; and
- Compliance with laws, regulations, and contracts.

Reliability and integrity of financial and operational information

Internal auditors review the reliability and integrity of financial and operating information and the means used to identify, measure, classify and report such information (Pickett, 2010). In large organisations, a significant number of transactions is usually processed on the system and the organisation relies on the system to ensure that the transactions are recorded properly and that the information obtained from the system is correct, this includes tax information. When internal auditors review the reliability and integrity of financial and operational information, the organisation can get comfort that the system is working effectively.

Effectiveness and efficiency of operations

In addition to reviewing the reliability and integrity of financial and operational information, internal auditors should also review whether resources are used in an economic and efficient manner. They should also review operations or programmes to ascertain whether results are consistent with established objectives and goals and whether the operations are being carried out as planned. (Pickett, 2010)

The review of the effectiveness and efficiency of operations is applicable for many areas of the business, including tax.

Safeguarding of assets

Internal Auditors should review the means of safeguarding as well as verifying the existence of such assets (Pickett, 2010). The acquisition of assets can have various tax implications. The existence of such assets can also have continuing tax implications for an organisation, thus, safeguarding of assets by internal audit as part of the assurance activities is also relevant when reviewing the tax operations.

Compliance with laws, regulations and contracts

Internal auditors should review the systems or controls implemented to ensure compliance with applicable policies, plans, procedures, laws, regulations and agreements, which could have a significant impact on operations and reports, and should determine the organisation's compliance status (Pickett, 2010). It is important for an organisation to know their compliance status (including tax compliance status) across their different business operations as it affords them the opportunity to take corrective measures.

Internal audit reviews the extent to which management has established sound systems of internal control so that objectives are set and resources applied to these objectives in an efficient manner.

Information systems and published reports are adequate.

According to (Pickett, 2010), the internal auditors can ensure that:

- Policies, procedures, laws and regulations are complied with; and
- Assets, including the corporate reputation, are protected.

As discussed above, the status of compliance with the relevant rules etc. should be determined. The organisation's reputation can be said to be one of its greatest assets. This asset can be protected by ensuring that the organisation complies with the relevant (e.g. tax) policies, procedures, laws and regulations.

4.3. The role of the tax function in the internal audit process

The design, deployment, management and measurement (and ultimately improvement) of effective tax controls requires a clear understanding of the origins of the very risks those processes are designed to address and mitigate. (Ernst & Young, 2014)

Generally, the internal audit team does not consist of tax professionals and as a result, tax subject matter experts can be consulted to get assurance that all the relevant tax risks are addressed and appropriate action will be taken to mitigate historic and potential future exposure. The tax experts can assist with translating the tax technicalities of the tax risks identified so that they are easily understandable to the other stakeholders. This can be done by translating these risks into impact on the overall tax risk profile of the organisation.

According to Deloitte United States of America (2011):

> The complexity around tax translates into risk for most organizations. Accounting for income taxes continues to be a leading cause of material weaknesses. Managing tax risk, however, involves more than avoiding errors in financial and tax reporting, but also requires that the right governance, structure, and protocols are in place to recognize the value of rewarded risk-taking gained through appropriate tax planning. The internal audit function in many complex organizations may not always have the depth of technical knowledge necessary to undertake a tax risk assessment, evaluate the appropriateness of controls, and assess the validity of mitigation factors.

Tax subject matter specialists can provide insights to the internal resources that conduct a tax risk assessment and advise in the efforts to develop a plan to bring tax into the regular internal audit cycle, or provide a renewed perspective on the company's existing tax risk assessment and audit plan. Deloitte United States of America, 2011.

According to Sassano and Baron (2013:34), the Internal Audit Director has the responsibility to decide whether to involve tax subject matter experts during the internal audit of the tax function. The following reasons may influence the Internal Audit Director's decision:

- The internal audit team does not have the tax technical skill set – this is typically the case;
- Audit plan hot spot by audit committee or corporate executive board;
- Need to find best practice and process improvement opportunities;
- There is turnover in the tax department;
- Components of tax function require outside support; and
- Poor communication between tax and accounting.

In assisting the internal auditors during the internal audit of tax, the tax specialist can do the following (Deloitte 2014):

- Articulate their understanding of the tax lifecycle - from seeking to evaluate and potentially influence tax law change, through tax planning on prospective business decisions to preparing, filing, and defending tax returns.
- Identify categories of tax risk that arise in this lifecycle - including redetermination of a technical position taken and noncompliance with applicable laws - and how they fit within the organizational risk architecture.
- Understand, assess, monitor, and mitigate their tax risks through effective procedures and processes incorporated within the organization-wide "three lines of defence model" enabling management of operational and cash-flow risks, such as overpayments. (The three lines of defence traditionally include the business units (first), risk management (second), and internal audit (third).)
- Identify, analyse, review, and discuss with management business decisions, processes, and transactions that hold significant tax consequences and tax risks.
- Communicate the overall tax-risk profile, with aggregated data for the exposure by relevant segment, such as jurisdiction, tax type, and counterparty, to assist senior executives, business unit leaders, and board or board risk committee members in assessing and overseeing those risks.
- From the above, it is clear that there are a number of factors to be considered in deciding whether or not tax subject matter experts should be involved during the internal audit of taxation.

5. CHAPTER 5: INTEGRATING TAX RISK MANAGEMENT INTO THE INTERNAL AUDIT PROCESS

Drawing on the findings of their two Global Tax Risk Surveys in 2004 and 2006, Ernst and Young say that effective teaming of tax and internal audit could be the way forward in helping to manage tax risk across the enterprise:

> This is all part of a wider recognition by boards and audit committees that in order to have a complete picture of an organisations risk profile, there needs to be proper consideration of the tax consequences of doing business.
>
> From a financial statements perspective, without effective processes and controls in place around tax, there is a significant possibility that the tax numbers and related financial information disclosed in the business's annual accounts could be inaccurate or incomplete.

Ernst & Young believe that one way of managing this risk is to integrate tax into the business's enterprise wide internal audit program to ensure that all tax issues are identified and given appropriate scrutiny.

Ernst and Young report that their 2006 Global Tax risk survey indicates that, 35% of businesses are planning to increase internal audit involvement in the review of tax processes and controls. They advocate that this approach will help to reduce the overall tax risk profile of the business and potentially increase its competitive advantage. (OECD, 2009:21)

Internal audit's entity wide perception of risk can help the tax function identify and mitigate a much wider range of exposures. The two functions can learn from each other's skill sets, and teaming may help reduce some of the pressure on overloaded and under-resourced tax departments. Cummings (2008).

According to (Bennecke and Lau, 2012:5), today's internal audit environment has changed in the following ways from 2002:

- Shift in focus from reporting and compliance requirements to strategic, operational and financial maturation of an organization's processes;
- Reliance on Internal Audit to identify linkages between departments and mitigate the related exposures;
- Leveraging subject matter experts to gain in-depth knowledge of the various process areas;
- Expectation of collaboration between Internal Audit and the various departments to further enhance process and control best practices; and

- Leveraging internal audit work to gain external audit reliance.

According to (Bennecke and Lau, 2012:8), in meetings with several Internal Audit Executives, the following was learned:

- Internal audit departments typically rely on support outside of their function when it comes to tax; and
- Dedicated internal audit service providers many times need to collaborate with others to provide technical expertise with respect to tax.

The reasons for considering collaboration between the internal auditors and tax subject matter experts has been discussed above. The approach to the collaboration is analysed below:

5.1. Approach

A number of professional services firms have developed an approach to conducting internal audits with assistance from the tax subject matter experts. According to Deloitte United States of America (2011:1), experience providing tax internal audit services to a wide variety of clients has led them to develop a flexible level of internal audit assistance that can include:

- Identifying specific areas for client's risk assessment coverage;
- Generating questionnaires for individual interviews on specific topics;
- Documenting interviews and test results;
- Assisting in the design and execution of tax internal audit testing; and
- Analysing potential solutions for remediation.

Some of the big four audit firms offer organisations services in relation to assistance and advice to design a solution that is integrated with the organisation's overall approach to risk management (not just tax risk management) that supplements the organisation's resources with a wide variety of tax subject matter specialists. (Deloitte United States of America, 2011)

According to Grant Thornton (2013:6), the key objectives of an internal audit of taxation are as follows:

- Confirm that a responsible approach to the management of taxes has been adopted;
- Demonstrate a sound control framework exists over tax risk;
- Ensure tax risk is managed in line with other key corporate risks;
- Establish if tax risk is being managed in line with the group's risk appetite;
- Identify opportunities to improve tax related controls;
- Clarify tax related governance framework and roles and responsibilities; and
- Reduce likelihood of tax related errors.

The following can be the approach to auditing tax Grant Thornton (2013:8-12):

1. *Understanding the business and tax set up*

- Identify the key people to interview - Head of tax, Financial Director, External Audit, Tax advisors, Human Resources;
- Key business factors to consider - Jurisdictions, areas of business, role of external audit, role of other advisors / consultants, overseas trade; and
- Understand relevant factors in the external environment - Peers activities, public or regulatory focus.

2. *Establishing the scope - identifying key tax risks and controls*

- Clearly understand the ownership of the "tax universe" and the role of the tax team in relation to this universe;
- Identify prioritised tax risks and associated controls, e.g. VAT, PAYE, Corporation Tax;
- Establish if there is a tax strategy, what the details are, and who owns this;
- Understand the role and capability of the second line of defence in relation to tax;
- Obtain the perspectives of relevant tax, finance, board, committee and business unit personnel; and
- Understand use of tax tools and any possible information technology auditing.

3. *Develop a tax internal audit plan and execute*

- Develop tax internal audit plan covering highest priority taxes, processes, business units or jurisdictions;
- Link to skills of the delivery team; and
- Plan may cover processes in tax function, finance, accounts payable, human resources, payroll, business units, third party providers, information technology; and
- Link to the understanding of the tax universe as any wider business ownership of the universe to be established to aid audit programme execution.

4. *Develop improvement plan*

Matters to consider include:

- Alignment to the tax strategy;
- Benchmarking against peers and best practice; and
- Alignment to other company policies / documents.

According to Deloitte Australia (2011), the following can be the approach to auditing tax:

1. Understand the business and develop the scope

- Interviews with head of tax and head of internal audit to understand taxes, processes, business units and jurisdictions in scope; and
- Develop interview / workshop plan and tailored questionnaires.

2. Assess key tax risks and controls

- Risk assessment interviews with relevant tax, finance and business unit personnel;
- Agree risk assessment criteria (impact and probability); and
- Document prioritized tax risks and associated controls.

3. Develop tax internal audit plan

- Develop tax internal audit plan covering highest priority taxes, processes, business units or jurisdictions; and

- Plan may cover processes in tax function, finance, accounts payable, accounts receivable, human resources, payroll and business units.

4. Undertake tax process reviews and controls testing

- Undertake tax process reviews via interviews, walkthroughs and document reviews;
- Conduct internal control testing;
- Evaluate review findings; and
- Prepare written findings and tax risk and control register.

5. Develop improvement plan

- Develop recommendations to improve inadequate or ineffective processes and controls;
- Present audit findings to stakeholders; and
- Where appropriate, assist client with implementation of improvement plan.

According to Cummings (2008), Ernst & Young describes collaboration between tax and internal audit as varying along a continuum from review and validation to competitive advantage:

1. **Review and validation** - at this level, internal audit provides its traditional services relating to audits of tax processes and controls, for example by reviewing and strengthening tax technology documentation, controls, and security. At the same time, internal audit works with the tax department to start to develop an enterprise-wide view of tax risk and to identify any exposures that need to be addressed immediately.

2. **Continuous monitoring** - this enables the organization to incorporate tax within its annual enterprise risk assessment and address new risks through the internal audit report remediation plan. Activities at this stage might include, for example, monitoring post-acquisition integration tax requirements, including completion of tax elections.

3. **Process improvement** - this is where internal audit's expertise in best practices for processes and controls comes into play. Companies are leveraging that knowledge to standardize and automate labor-intensive tax accounting and compliance activities, freeing up tax managers to focus on key risks.

4. **Competitive advantage** - at this point, the tax and internal audit departments are working together to integrate tax risk processes into strategic business planning. This allows the tax function to shift from its traditional focus on short-term fixes to a long-term view of sustainability and business improvement.

Tax internal audit services provided by some of the big four audit firms may include:

- Accounting for income taxes and tax compliance:
  - Spreadsheet controls
  - Analysis of deferred tax balances
  - Tax basis balance sheet assistance
  - Data quality and integrity
  - Tax planning
  - Valuation allowances
  - Uncertain tax positions
  - Legislative and regulatory changes
- Tax provision software implementations
- Tax technology assessments
- Tax department efficiency assessments
- Transfer pricing
- Custom and excise taxes
- Sales and use
- Shared-based compensation
- Employment taxes
- Document management/record retention
- Tax controversy management
- Information reporting
- Foreign jurisdictions:
  - Accounting for income taxes
  - Corporate governance
  - VAT
  - Qualification for tax holidays
  - Import export taxes
  - Tax audits and controversy

Source: Deloitte United States of America (2011)

5.2. Benefits or value added to organisations by the integration

According to the Australian Tax Office (ATO) (2017), they have embraced the increasingly global view that tax risk management should be a part of good corporate governance. The presence and testing of a tax internal control framework are an integral part of the risk-assessment protocols used by tax authorities.

By integrating tax risk management into the internal audit function, organisations can ensure that strong tax internal controls are implemented for all tax risks identified. This will give tax authorities comfort that the information provided by the organisations during a risk assessment or an audit is reliable. The other benefits/ value added to organisations by integration between internal auditors and the tax subject matter experts are analysed below:

Integrating risk management functions with other areas of the organization is an area of great opportunity for internal audit, the survey concluded, but at this point only 29 percent of respondents reported significant interaction with other risk management functions in the company. Internal audit and other risk managements should engage in knowledge sharing, specifically information about risks and controls. (Accounting Web, 2007)

According to Deloitte United States of America (2011), the advantages to the integration between tax and internal audit include (amongst others), the following:

- Access to tax specialists with extensive experience;
- An approach that is tailored to the organisation's internal audit software and documentation methodologies;
- Cost-efficient utilization of specialized technical resources;
- Greater alignment of tax internal audit coverage across significant business functions impacted by tax; and
- A more robust internal audit tax plan with the goal of improving controls.

According to Deloitte Australia (2010), the advantages to the integration between tax and internal audit include (amongst others), the following:

- Demonstrate increased control of tax risk issues to the audit committee;
- Reduce tax authority risk ratings;
- Raise the profile and efficiency of the tax function;

- Reduce the likelihood of tax errors and misstatements;
- Clarify tax related roles and responsibilities throughout the business;
- Consistent assessment of tax risk across all jurisdictions;
- Knowledge transfer to the internal audit team;
- Identify opportunities to improve tax related controls in divisions;
- Integrating tax risk reviews with the internal audit process across all tax types;
- Access to tax specialists with extensive industry experience and cost-efficient utilization of specialized technical resources;
- Greater alignment of tax internal audit coverage across significant business functions impacted by tax; and
- A more robust internal audit tax plan.

According to Ernst & Young (2008), given the increasing pressures on time and resources, many tax functions are seeking to manage their tax profile by meshing together the tax technical skills of the tax function with the process and controls experience of the audit department, and embedding tax considerations into the organisation's audit plan and some of the advantages or benefits of integrating tax and internal audit are as follows:

Integrating tax and internal audit will not only help to manage and reduce the overall tax risk profile of an organisation, but it will also potentially increase the competitive advantage of the business.

Jonathan Blackmore, Risk & Advisory Services Director at Ernst & Young agrees with this view and has stated that:

> Leading organisations have come to recognise that in order to manage this combined skills gap, they need to bring the internal audit department and tax function together to address tax risk management jointly across the enterprise.

Blackmore has also stated that that in most organisations, the internal audit function is the board's most powerful mechanism for understanding and providing semi-independent validation and monitoring around the spectrum of risk facing the organisation.

> Involving internal audit makes it easier for all areas of tax risk across the enterprise to be identified, rather than just those situated in the tax and finance function.

Another benefit according to Ernst & Young (2008) is that improvement in tax risk management gained through integrating tax and internal audit allows the internal auditors to evolve in their approach and move away from testing controls on individual transactions to evaluating the effectiveness of management efforts and internal controls in relation to overall tax risks in the organisation.

Integration between tax and internal audit can also promote the development of a 'leading practise' corporate environment. The benefits are likely to also increase over time, creating real competitive advantage for organisations if leveraged correctly (Ernst & Young, 2008).

From the above, it can be said that where a robust internal audit plan of taxes is prepared by the internal audit specialists in collaboration with tax specialists, there can be a consistent approach applied in the review of taxes in organisations. This can result in benefits or advantages for the organisations.

6. CHAPTER 6: CONCLUSION

6.1. Concluding remarks

The percentage of organisations with a dedicated tax risk management role may have dropped slightly since 2011, however, organisations state that they are actually spending more time than ever managing tax risk and controversy. (Ernst & Young, 2013:11)

> Survey respondents say they are spending slightly less time on financial reporting and tax planning than in 2011 (about 5% and 6% less, respectively, among the largest companies globally) and more time on managing routine tax compliance and disputes / controversy (about 9% and 11% more, respectively, among the largest companies).

In managing tax risks, which seems to be a significant activity in many organisations, it is important to consider that many risks are not arguments around deep, tax technical interpretation but instead about whether an organisation has the capability to find and correct errors before they get out of control. Organisations need to consider whether they are thinking deeply enough about how they can position their tax function in a way that enables them to manage their operational tax risks. (Ernst & Young, 2013:3)

According to Elgood, (2004:53) organisations make money by taking risks and making money is the primary objective for most businesses. Tax risk management is about a considered approach to tax risks relevant to the business and not about trying to completely eliminate the risks.

In an attempt to document the an approach that can help an organisation to find and correct errors before they get out of control and also potentially position the tax function in a way that enables it to manage tax risks;

Chapter 2 provided a brief overview of tax risks, focusing on the types of tax risks, sources of tax risks and the most common types of taxes embedded with tax risks. In particular, this chapter highlighted the need for organisations to understand the tax risks that may be applicable to them in all the jurisdictions where they have operations, to ensure that they are able to manage such risks.

Chapter 3 discussed the tax risk management process. In particular, the role of the tax function and the internal audit function in managing tax risks was analysed.

Chapter 4 discussed the internal audit process. In particular, the analysis of the role of the internal audit function and the tax function in the internal audit of taxes was carried out.

Chapter 5 contextualised the theory presented in Chapters 2, 3 and 4. It discussed the integration of tax risk management into the annual audit cycle. This was done using the material made public primarily by professional services firms based on their research, discussions with their clients, new service offerings introduced etc. At the same time, the chapter analysed the advantages or benefits of the integration in support of the theory that integrating tax risk management in the annual internal audit cycle can improve tax risk management.

In light of the analysis above, it can be said that until an organisation appropriately integrates tax into its overall approach to risk management, the job in relation to tax risk management is incomplete.

6.2. Further research

Firstly, it must be noted that this research was exploratory in nature, based on an interpretive approach analysing literature from all over the world. Further research may therefore include a practical review of the tax risks that can typically be found across different industries and the procedures / controls that can be implemented to effectively manage those risks.

A risk based internal audit plan should be documented to address the tax risks identified as part of the practical review and to provide assurance that the recommended procedures / controls are effectively mitigating the risks. The risk identification, control recommendations as well as the internal audit plan should be performed / prepared with input from both internal auditors as well tax subject matter experts.

This particular area of tax risk management has not been researched in detail, offering many opportunities for future academic efforts.

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