



Tough tax demand for audit committees

Tax has risen up the audit committee agenda in recent years as a result of calls for global companies to be more transparent about what they pay and where. *Ken Arthur* looks at how committees should assess the risks associated with tax policies, including the threat of reputational damage.

Tax has become a highly sensitive political issue recently, with multinational companies (MNCs) accused of not paying appropriate amounts in some of the countries in which they operate. Governments, tax authorities and campaign groups are seeking greater transparency – and this has significant consequences for company boards and their audit committees.

News stories from around the world frequently highlight what is described as “aggressive tax planning.” These stories are fueled by the disclosure of private legal and financial information – such as the so-called “Panama Papers” – and have led to public criticism of large MNCs. In response, governments and institutions such as the European Union (EU) have started to act with a level of coordinated action that is rarely seen.

The best example is the Base Erosion and Profit Shifting (BEPS) project from the Organisation for Economic Co-operation and Development (OECD) and Group of 20 (G20) countries. Under BEPS, a 15-point action plan, described by the OECD

and G20 as the “most significant rewrite of the international tax rules in a century,” was approved in November 2015.

It seems inevitable that collective action on corporate taxation will grow, creating a dilemma for global companies as they weigh up the risks and the possible impact of any controversy and bad publicity. Audit committee members need to be aware of the risks associated with tax policies. Changes to tax policy require companies to gather more information, provide it in different forms and report it in different ways.

TAX TRANSPARENCY

Greater transparency on corporate taxation is being encouraged on at least three fronts, each having an impact on the audit committee:

1) Increasing requirements for country-by-country (CbC) reporting

Under BEPS Action 13, companies with group revenues of at least €750m will have to report

revenues, profit before income tax, income tax paid and accrued, total employment, capital, retained earnings and tangible assets in each jurisdiction in which they do business. The objective of the CbC report is to provide tax authorities with an overview of global operations, showing where income is earned, staff are located and taxes are paid. The OECD proposal recommends that this applies for fiscal years beginning on or after 1 January 2016, but the commencement date in each jurisdiction will depend on the speed of national implementation. Financial information will be exchanged automatically on an annual basis with the tax authorities where the MNC operates. However, BEPS does not require the information to be reported to the public.

Audit committees will need to be aware of the new tax-related disclosures that are required, make sure that the appropriate data are available and understand the consequences of the information being shared among tax authorities. Sharing of data brings a number of concerns, including issues with translation and context. It should also be remembered that tax-related problems are a major element in financial restatements and where material weaknesses are identified in internal controls.

2) Greater disclosure of information to the public

BEPS may not require public disclosure under Action 13, but this is still a likely outcome in many countries. For instance, on 12 April 2016, the EU proposed legislation that would force companies in Europe with revenues above €750m to disclose publicly their tax and profit information for individual countries. They would also be required to disclose how much tax they pay on the business they conduct outside the EU, as well as other information concerning employees and the nature of the activities performed in each jurisdiction. This is not just an EU issue – it will affect MNCs with European subsidiaries, and what starts in Europe often tends to spread further. Public disclosure of selected information is a phenomenon that already affects banks in the EU (which have been required to make such disclosures since 2014 under Capital Requirements Directive IV), as well as extractive industries.

Audit committee members should assume that financial information will be made public and determine whether there are likely to be any issues to deal with when this happens. They need to help establish the right approach – balancing the desire for reducing tax with reputational concerns – which will involve integrating tax strategy with risk management.

3) State aid investigations

The European Commission's competition directorate is increasingly questioning perceived

deals. The directorate has highlighted preferential tax agreements that, it argues, constitute illegal state subsidies. This issue is of particular relevance to US-based MNCs, a number of which have faced probes. This has led the US Treasury Secretary Jack Lew to write to the commission claiming that US companies have been unfairly targeted.

This situation creates uncertainty for audit committee members, who will want to know whether the particular tax treatment of their EU companies could be construed as state aid. The consequences could be significant, with companies potentially having to repay any aid received. It has implications for past and future tax liabilities and could also affect decisions on mergers and acquisitions.

REPUTATIONAL RISKS

Audit committees need to consider the impact of all three issues as part of their risk assessment. Members have to understand the reputational dangers and be aware of the – sometimes contradictory – forces affecting the company. They should be checking that the company is prepared for this and can answer detailed questions.

Audit committees should also consider whether the company has a robust and transparent relationship with the relevant tax authorities. This can create more certainty about tax treatment and, when problems do arise, allow for a faster dispute resolution, given greater understanding of the background.

Questions for audit committees to consider

- ▶ Do you know what tax strategy your company is adopting or the parameters by which it is deciding that strategy?
- ▶ Does management know what the CbC report will look like and what questions it will give rise to if and when it goes public?
- ▶ What is the company's exposure to state aid risk?
- ▶ Does the tax department have enough resources to operate effectively?
- ▶ Is the audit committee confident that the tax function is able to clearly identify and manage ongoing risks, disputes and litigation?
- ▶ Is adequate investment being made into the tax function to allow the company to meet current and future tax compliance and reporting obligations, and to take advantage of tax planning opportunities?



“Audit committee members should assume that financial information will be **made public.**”

It is particularly important to have a good relationship with the tax authority in the home country as, in the new environment, that tax authority may be required to argue its position in disputes with other jurisdictions.

Resources are certainly a factor. With companies expected to gather increasing amounts of data and to implement more nuanced tax policies, there could be a requirement for additional skilled staff in the tax department, more sophisticated systems and the creation of cross-functional teams (including representatives from the public relations department). These issues have to be discussed when determining budgets – and it is critical that the audit committee is aware of these decisions.

Corporate taxes are, of course, only one element of the discussion. For most companies, payroll taxes and VAT payments will be more significant, and the penalties for getting these wrong can be severe. So audit committees should make certain that they focus on all aspects of taxation.

Demands for greater transparency aren't going away. Audit committees should assume that tax will continue to be a reputational, as well as a financial, issue. Additional public disclosure is inevitable, with greater demands placed on the tax department. It will require significant oversight from the audit committee. ■

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Viewpoint



Appropriate answers to tricky questions

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The ongoing focus on taxation, in the press and at both the governmental and intergovernmental level, is resulting in demands for even greater transparency. Businesses are under increasing pressure to publicize financial information, aimed at demonstrating that where companies generate profits aligns with where they pay tax.

While such information has historically been kept confidential within the tax administration, in the new environment it is prudent for companies to assume that much of their financial information will become public, and to make sure that they are ready with appropriate answers to any challenging questions.

In addition, given that the information often lacks context, questions are likely to abound. For example, the information might show large numbers of people working in one country, but little or no taxable profit. But how this arises will vary, and could derive from the offset of losses incurred in previous years. Without context, this information will merely prompt further questions.

Even without public reporting, there are dangers that data can be misinterpreted. In the new, globalized environment, what is filed with one tax authority is readily shared with all tax authorities. Sometimes this can create confusion, especially if this involves the translation from one language to another.

In some circumstances, it may therefore be better voluntarily to disclose financial information beyond the tax authority, rather than be responding to questions at a later stage. The experience so far of companies that have shared information early is that, although they attract attention at first, if they can respond effectively, it can avoid challenges later.

The direction of travel is clear, and this is now a case of “when,” not “if” businesses will be called upon to produce that sort of financial information. Audit committees will want to make sure that the company's tax department is managing this process properly. Committee members should be aware of the potential for controversy and have a strategy in place to manage it, should the need arise.

Risk associated with controversy, reputation and bad publicity has to be managed. The audit committee will want to keep this issue near the top of its agenda.

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