VAT automation is a mission-critical investment

Automating VAT tax calculations reduces risk as more countries adopt VAT style taxes and look to them for increased revenue, explains Chris Walsh, chief international indirect tax officer of Vertex

For years, value added taxes (VAT) have been managed under the radar, often by just one person in the tax department. This person (or small team) handles VAT on sales and purchases and then reconciles amounts during the corporate tax process. The fact is that billions of dollars of VAT flow through large companies every year. And while companies may not be paying VAT on a net basis, they are managing and processing it in vast amounts that demand closer oversight.

Because VAT rarely shows up on annual reports and other critical accounting documents, it is largely an invisible tax – one reason why it often gets less attention than it should. Large companies often use native enterprise resource planning (ERP) tax processing functionality to manage VAT, which means they must manually input tax data on the countries where they do business, which raises risk through knowledge gaps and human error that should strictly be reported in the accounts through a VAT provision.

The problem is that VAT tax data can quickly become obsolete. For example, if a tax department centrally manages a multi-country VAT position, its tax professionals may not know that a country they have been working with for years recently changed its VAT rates, rules, or policies. To stay up to date, someone must constantly monitor VAT changes around the world, register the business wherever such taxes are due, and update their company's ERP system manually – a significant maintenance effort that is error prone and risk laden at best.

VAT under scrutiny

With the global economic crisis, VAT is no longer invisible. In fact, it is receiving more attention than ever. As a result, every international business needs to take a more proactive approach to managing its global VAT position.

For example, VAT compliance requirements are becoming increasingly stringent, due in large part to Sarbanes Oxley legislation. In addition, many countries are implementing standard audit file requirements – reporting formats that dictate how companies need to present data on their VAT and other taxes to authorities. Because these formats make it easier for authorities to analyse data and look for errors and underpayments, it is more important than ever for companies to ensure the accuracy of VAT calculations.

Meanwhile, the global credit crisis has prompted a heightened focus on VAT by both company executives and governments. Executives are pressing tax and finance departments to find new cost, cash management, and process savings. Long ignored by upper management, VAT is finally getting the scrutiny it deserves, as it can often represent up to 25-35% of a company's total cash throughput.

Simultaneously, governments are looking to VAT to bridge growing gaps between budgets and revenue from income tax. More countries are replacing sales taxes with VAT taxes, changing VAT rates and regulations to boost revenue, and scrutinising corporate tax data to make sure nothing falls through the cracks.

> More countries are replacing sales taxes with VAT taxes, changing VAT rates and regulations to boost revenue

Given these conditions, every VAT-related process and activity should be viewed as an opportunity for error and potential business risk. If a business is not properly registered in a given country, unintentionally charges the wrong VAT amount (or fails to charge it at all), government bodies will eventually learn of the oversight. Penalties are punitive, and bottom line impact can be significant.

Chris Walsh: automating VAT is the way forward

A better way to handle VAT

Because of the increasing challenges, costs, and risks associated with VAT, more tax and finance departments are looking for better ways to manage VAT – most notably by deploying software that automates VAT data updates and calculations.

These applications (or tax engines), which bolt onto existing ERP systems, contain vast amounts of tax data needed to drive an accurate tax determination. Vendors are responsible for applying comprehensive, stringent processes to capture, update, and ensure quality control of the tax data used in these systems.

This means that corporate tax departments that deploy VAT automation are no longer required to monitor all of the countries where they do business or update their ERP systems manually. It is done automatically, and is always up to date.

A tax engine gives tax departments more control over VAT because the software can be actively managed by corporate professionals, usually without IT assistance. For example, tax professionals can modify the software as the company's VAT footprint and taxability profile changes.

At the same time, VAT automation reduces business risk. Because VAT calculations are automatically generated based on tax data, companies are ensured compliance regardless of where they do business. The software can also perform automatic reconciliations between VAT reports and the general ledger, which reduces Sarbanes-Oxley risks. Also, if a company initiates business in a country where it is not registered, the software can prevent non-compliant events from occurring and send an alert to the appropriate in-house tax professional.

Companies using a tax engine also benefit from:

- Direct and immediate access to a global, up-to-date overview of the company's VAT position (or any group company)
- Flexibility to check and change taxability decisions in real time
- Reduced process costs due to automation of manual tasks and faster reporting
- Improved cash flow by ensuring companies don't pay VAT earlier than they need to
- Fewer errors and assessments as manual Accounts Payable (AP) and Accounts Receivable (AR) processes are replaced
- Audit trails that enable accelerated, less costly audits
- Executive-level insight and confidence in how VAT is being handled
- Automatic generation of the standard audit files and other reports required by different countries
- Reduced time spent in audit defence

Using automation to solve common issues

The following sections highlight some of the most common VAT issues faced by multinational companies in any industry sector and briefly addresses how – and to what extent – a VAT tax engine might address them.

Issue 1: Human error

Most financial systems rely on AP and AR clerks to correctly apply VAT tax codes to individual purchase and sales invoices. These personnel are rarely technically equipped to make those decisions, resulting in errors, tax assessment, and penalties.

Tax engines remove the need for manual tax code selection. Instead, data elements passed from the financial system (such as ship-from, ship-to, bill-from, bill-to, product code, and customer data) are used by the tax engine to automatically derive a tax determination. In this way, automation removes the opportunity for human errors, which occur so frequently during manual VAT coding.

Issue 2: Global oversight

Global and regional tax managers typically do not have visibility into, or direct control over, the tax positions of the businesses they manage.

Tax automation software can help by improving visibility and control. Using appropriate access controls and permissions built into the software, a tax manager based in a central location can view and even amend taxability decisions being made within the tax engine anywhere within his jurisdiction. In addition, within a single instance of the automation software, a tax manager can generate reports of tax, management, and logistical data worldwide using a real-time environment.

All multinational businesses face different VAT difficulties related to transaction types and business models

Issue 3: Tax research effort

In most cases, global and regional tax managers do not have the time, or access to the information needed, to research changes in the VAT regimes for all of the countries they manage. Even when they do, they rarely receive relevant information in a timely manner, which forces tax decisions based on obsolete information.

When tax departments deploy a quality VAT automation tool, they no longer have to worry about performing tax research and system updates. Tax engines are able to provide tax data from around the globe that is highly quality controlled and risk managed, a key selection criterion for anyone involved in selecting a good VAT tax engine. This data should be updated every month and through interim updates as required. As a result, tax managers receive high-quality tax data in a near real-time way. In addition, the data can be applied to the tax determination process in the most efficient manner possible, without any need for the tax manager to perform research.

Issue 4: Granular reporting

Native ERP reporting functionality is limited in terms of the VAT data views that are provided by vendors. This makes the creation of custom reports an expensive and time-consuming option, especially for today's busy and often understaffed tax departments.

VAT automation products address this challenge by automating report generation. Specialised tax engines can access more than 140 different transaction-specific data elements, including flex fields that can be defined by the user. Using any combination of those data elements, users can generate user-defined reports in a matter of minutes through drag-and-drop report building software.

As a result, tax managers gain ready access to VAT information at a much more granular level. They also can include many non-tax data elements (such as logistical data) that are not always accessible within a native ERP environment.

Issue 5: Staff training

Accounting staff attrition often results in tax managers training and re-training colleagues to handle VAT within the business.

With a VAT automation solution in place, the software makes the tax determinations – not people. As a result, the level of VAT expertise required by AP and AR staff is greatly reduced, thereby minimising VAT training requirements for users.

Issue 6: Poor visibility

Most businesses' profit and loss (P&L) or balance sheets provide no insight into VAT. Although ERP systems are able to

KPMG survey: governments worldwide are focusing on indirect taxes such as VAT

Three quarters (75%) of respondents expect their government to rely more on VAT/GST for tax revenues in the next five years.

- 50% of global finance directors rated errors in VAT compliance as the top global tax risk for their organisation, significantly ahead of corporate tax risks (38%).
- 82% of global businesses prepared to give an estimate said their total annual VAT throughput was between $200 million and $1 billion.

produce VAT reports, they are not usually sufficiently granular to be of much use in cash or management accounting terms. This means that VAT often flies beneath the radar of internal and external auditors, despite the fact that VAT can represent up to 25% of the cash moving through a company.

In contrast, a VAT automation product includes a tax engine with highly sophisticated reporting functionalities, enabling tax managers to produce more detailed and valuable tax information at a taxpayer level. These reports make it much easier to identify and address issues and planning opportunities.

Issue 7: Sarbanes-Oxley 404

Many companies' internal controls related to VAT are weak, disjointed, or non-existent – a real problem in today's post-Sarbanes-Oxley (SOX) environment. Lack of control can leave CEOs and CFOs feeling exposed when signing off on the company's internal controls assurance documents, and for good reason. What they don't know can hurt them.

VAT automation tools can assume most of the burden of maintaining VAT-related management controls. These products offer support for robust risk management and quality control processes for data gathering and staging into the application.

Additionally, these products can also provide in-house VAT specialists with a global overview of the business's VAT position, which facilitates improved internal visibility into potential issues. This in turn allows for global consistency in VAT management and reporting.

Issue 8: M&A VAT issues

The collective VAT issues connected with mergers and acquisitions (M&A) make it one of the most troublesome and complex of all VAT areas. Specifically:

- The VAT on some costs of selling shares in the company may not be recoverable.
- As of a specific date, two sets of accounting records need to be brought together.
- One of the reasons for M&A activity is to achieve greater geographic coverage, so it is likely that the newly purchased company is operating in countries where the new parent has little or no expertise in the local VAT systems.

VAT automation tools can help in several ways. First, they can restrict the recovery of input VAT at a number of different levels, such as a cost centre level or at individual invoice level. The restriction can be all or part of the VAT charged. Second, some tax engines can integrate with the systems of the newly acquired company to create a single source for VAT reporting.

Thirdly, because the VAT automation software is pre-populated with the correct rates and rules applicable in VAT jurisdictions around the world, it doesn't matter if the acquiring company's tax staff does not have knowledge of local VAT issues. The software's tax data is kept up to date automatically, ensuring calculations are always correct.

Industry perspectives on VAT automation

All multinational businesses face different VAT difficulties related to transaction types and business models. VAT engines can provide, in part or whole, solutions to those issues. The following examples illustrate how VAT automation solutions can address these challenges.

Banks, finance & insurance companies

Financial services businesses such as banks, insurance companies, pension funds, and investment houses are partially exempt for VAT purposes, meaning that they are limited in how much of their input VAT they are able to reclaim. The percentage of their VAT that is recoverable will typically change in each VAT accounting period, depending on the split between the company's taxable and exempt supplies for each period. In this sector, VAT is a real cost to taxpayers, as it does not simply flow through their business.

Within the company's ERP system, tax managers must change their VAT recoverable percentage each month or quarter – and they must rely on their IT professionals to do that work. This updating can be time consuming, as recovery percentages can be attached to numerous entities, departments, activities, and other variables within the system.

Tax engine solution

At the moment, tax engines are not capable of calculating the recoverable percentage that a bank may be able to claim without significant customisation of their calculation logic. But once that manual process is completed by the tax manager, a tax engine can apply that percentage consistently at various levels.

It is important to note that methods of calculating the recoverable percentage can vary widely between banks and even within a single bank; they may employ a separate calculation method for each department or activity within the organisation. For this reason, tax engines can apply many user-defined recovery percentages by taxpayer, cost centre, or even at an individual invoice level, giving companies a great deal of flexibility and consistency in restricting non-recoverable VAT.

Although VAT automation applications cannot yet calculate the recoverable percentage, their

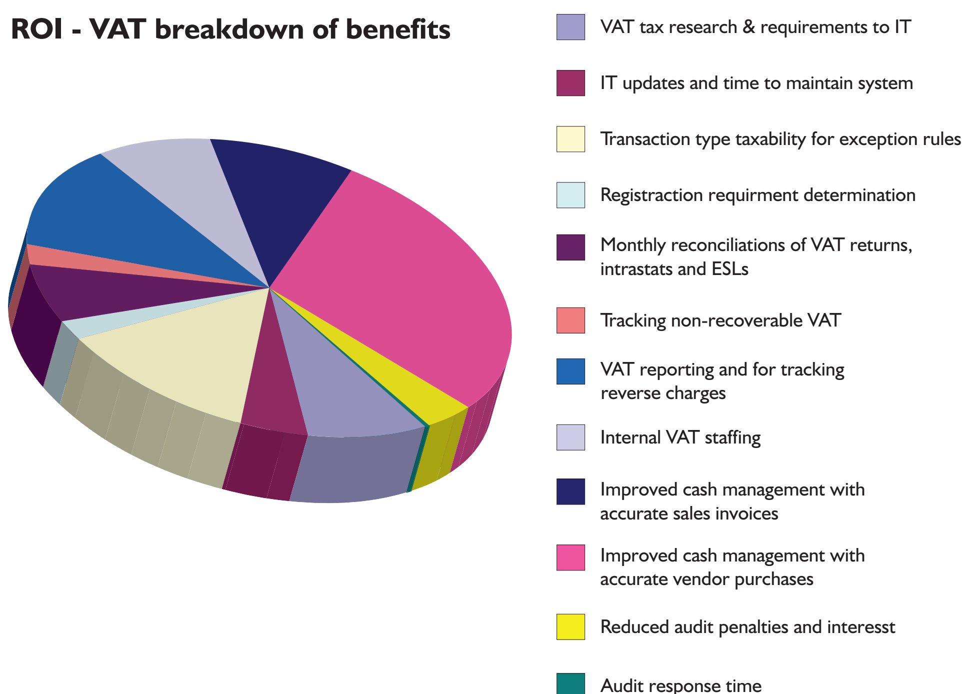

Diagram 1

reporting tools are very useful for generating the data needed by the tax manager to perform this task. Reports can be run using multiple criteria, enabling the tax manager to access the required data fields quickly and easily.

Consulting & general services companies

Place of supply (situs) issues are among the most common VAT problems facing companies that provide professional services. One of the key questions they need to answer is, in cases where consultants visit clients' sites in other countries, should VAT be charged on the basis of the country in which the work was carried out? Or should it be calculated on the basis of their home country?

Tax engine solution

The latest VAT automation bolt-on products include comprehensive place of supply rules as they relate to the supply of cross-border services. In addition to the situs rules that are mapped to specific service categories, these products also allow users to select particular situs treatments for direct mapping of their service product codes. Situs treatments that may be directly mapped include, among others:

- services supplied where performed
- services supplied where received
- services supplied where the customer belongs
- services supplied where the supplier belongs

It should also be noted that changes to the place of supply rules (such as those contained in the EU VAT package that comes into effect on January 1 2010) should be fully automated within a tax engine. This means that tax engine users will have little or no manual changes to make in their accounting systems when the VAT package takes effect.

Manufacturing

Manufacturers of goods that attract high levels of customs and/or excise duties often make use of bonded warehouses and free trade zones, as these locations allow the manufacturer to suspend payment of those duties, along with any associated VAT. ERP systems are not capable of calculating tax at one point in time and declaring it as due at a later date.

Suspending VAT on goods that are entered into a bonded warehouse is a difficult thing to do, as it requires the VAT tax engine track goods across a time period. But today, the most sophisticated tax engines are capable of managing this type of position effectively and with a high degree of automation.

More countries are implementing VAT

Just over the next 12 to 18 months, expect to see the following additional countries implement a VAT:

- Saudi Arabia
- Kuwait
- Qatar
- United Arab Emirates
- Oman
- Bahrain

In addition, China is considering eliminating its business tax and expanding the tax base for VAT beginning in 2010. India is in the process of moving its VAT from a state to a federal level.

Exporting

Exports of goods and services are usually zero rated for VAT purposes, but that zero rating is contingent upon the supplier holding evidence that the goods or services were, in fact, exported. Such evidence could include shipping documents (in the case of goods and contracts) and other commercial documents (in the case of services). Many exporters experience significant problems in backing up their zero-rated invoices with documentary evidence of export. Tax authorities will generally assume that, in the absence of such proof, that the goods or services were supplied domestically and as a result, should have been charged with the addition of VAT. As this VAT was not charged on the initial invoice, tax assessments are raised against the taxpayer.

The peace of mind automation can bring at the CEO and CFO level has become a significant factor in market adoption of these systems

While tax engines are not document tracking systems, some have document management capabilities that are effective in helping exporters track evidence of export. For example, companies can scan shipping documents into the application and then associate them with an invoice or transaction number so that they can be readily reconciled, if necessary, during an audit.

A rapid return on investment

In most cases, VAT tax engines can be fully implemented in three to six months. And the return on investment is quick and significant, delivering cost savings and risk reduction for finance, tax and IT departments, and even individual business units. In a real life example, a Standard & Poor 500 company with approximately $5 billion in revenue calculated a return on investment (ROI) of just under $7 million. The chart on the previous page illustrates the areas where the company expected to see this rate on investment (ROI) and the cost savings enabled by VAT automation.

But the peace of mind automation can bring at the CEO and CFO level has become a significant factor in market adoption of these systems. In this post Sarbanes-Oxley world, these executives need assurance that how they are handing VAT, which represents billions of dollars flowing through their business, is being handled correctly and consistently.

Taking the next step

VAT engines do not have solutions for every possible VAT issue. However, as these examples illustrate, VAT engines have now reached a point in their development where they are able to provide at least a partial solution to almost any imaginable VAT problem or process.

Because VAT engines vary so much in terms of architecture, functionality, data content, integration, flexibility, and maintenance and support, it's impossible to say that one particular VAT engine is better than another for every user.

As companies explore their options, the question businesses should be asking of their tax engine provider is not whether a VAT automation solution exists, but rather how complete and how automated a solution exists for their particular VAT footprint?

Equally important, is their product flexible enough to accommodate significant changes in their VAT footprint over time, for example, due to mergers and acquisitions, while maintaining true automation? Over-reliance on manual interventions undermines the value of the product over time, exposing companies once again to the growing risks and costs of VAT.

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