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Beyond Year One
The SAO Toolkit

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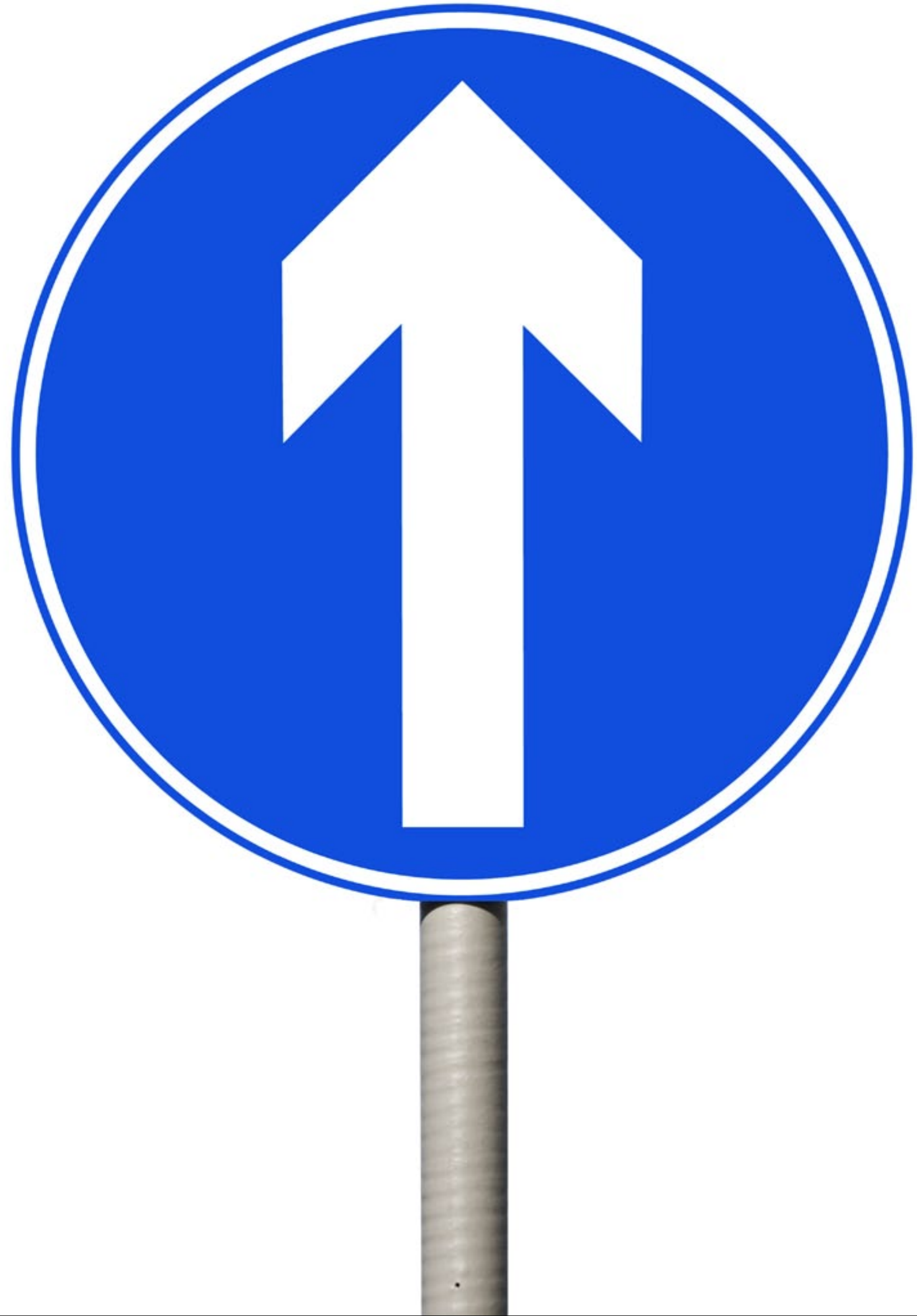


The SAO Toolkit – Part 2
May 2012

The Senior Accounting Officer ('SAO') legislation requires the company director or officer who has overall responsibility for the company's financial accounting to put in place and monitor controls over the calculation of UK taxes and duties and to provide an annual certificate disclosing any material issues.

The SAO requirements were announced in April 2009 and, after a short period of consultation, came into force on 21 July of that year. The effect of the new rules was to make a senior finance officer within a company or group, typically the Finance Director, personally responsible for its "tax accounting arrangements". That is, the collection of policies, people, processes and systems that enables the tax liabilities of the business to be calculated accurately and reported to HMRC.

Looking back at the last 3 years, what have we learned?

The **response of corporates** has varied considerably, with some undertaking a significant amount of additional work to support compliance while others have relied on existing sources of assurance.

Whatever the response, all those within the regime should now have submitted their first year certificate and our data indicates that approximately 30% of those have contained disclosures of material weaknesses or errors.

These disclosures have reflected a range of areas across the taxes within the regime which remain a significant challenge for companies.

What to keep in mind when managing SAO compliance beyond year one

The "light touch" of year one SAO compliance has now ended; so the bar has formally risen in terms of the "reasonable steps" HMRC expect to see SAOs taking. Exactly what is reasonable will depend on the scale of your business and its tax risks but, in general terms, SAOs and their businesses will need to ensure that any year one issues have been resolved and effective controls are maintained.

HMRC have recently issued revised guidance on SAO and this provides greater clarity on some of the more challenging aspects of the rules, including the circumstances in which penalties may or may not be levied. SAO is only one part of UK tax compliance, however, and should be considered in conjunction with all its other features, particularly the company penalty regime and HMRC's risk-based approach.

Ready, steady, sign

Finally, we set out the steps we believe you should have taken already or should take so that SAO is part of normal tax compliance work.

Looking back
What have we seen so far?

A mixed response

Since its introduction, we have seen a range of responses to the SAO regime. The first challenge is often who will fulfil the role of SAO. Some organisations, particularly those in which there is no single individual with specific control of tax processes, have found it challenging to select their SAO or SAOs, particularly if the business is decentralised or divisionalised. Others have found this easier, most commonly appointing the Chief Financial Officer or the Finance Director as the SAO.

At one extreme some groups have chosen to do very little additional work to support the SAO; other groups have conducted full reviews of all tax processes. Those that did little typically were assured by HMRC's comments that SAO does not represent a higher standard of care for those in the regime than for other corporate taxpayers and that they would not expect an otherwise compliant business to incur material costs as a consequence of these rules. SAOs in these businesses were also often helped by existing sources of comfort - including their tax team and advisers, existing internal control frameworks and external audit together with their tax compliance record.

In contrast, some SAOs have conducted a much more thorough review. In certain cases this has been an act of due diligence in response to the new law, but in many cases it has been driven by a change in circumstances within the company. A change in key personnel (e.g. the SAO themselves, the Head of Tax or others) may have meant that the trust which underpinned the existing sources of assurance was not yet at the level needed for sign-off. Another reason might have been that a significant tax issue was picked up by HMRC or the company's own review activity and this undermined the general level of confidence in the company's management of taxes.

The nature of the activity undertaken in these reviews has common elements but their extent will typically depend on the size of the business as the SAO groups range from the largest UK quoted multinationals to mid-size inbound groups. This is illustrated in the examples on the right.

Illustrative response of taxpayer	FTSE100	FTSE 250
Identify risks	Risk assessment exercises undertaken by project team for each tax. Team also collates risk information from Finance risk logs, Internal Audit reports. Significance and likelihood of risks assessed and action plan agreed with specific owners and timetable.	A half-day meeting involving the tax manager, financial controller and representatives from Human Resources and Payroll to discuss risk areas. Tax manager develops list of key risk areas to review.
Evaluate controls	Appropriateness of controls over key risks assessed through review of documentation and testing of returns. Where specific reliance is placed on existing controls, e.g. Sarbanes-Oxley, checks undertaken to test that scope of controls and testing is as expected.	High-level review of controls over key risks identified in workshop. Walk-through of processes and testing of outputs where recent compliance record indicates there are current issues.
Fix and test controls	Specific steps taken to address control weaknesses. Internal Audit undertake testing of improved controls and report to SAO.	Specific steps taken to address control weaknesses identified. Plan in place to test improved controls in year two.
Reporting	Regular meetings with the HMRC Customer Relationship Manager (CRM) to share SAO activity and to confirm understanding regarding issues disclosed during the year. Formal internal sign-offs from Tax, HR and Finance provided to SAO. Certificate submitted.	Meeting in advance of submission of certificate with CRM to discuss expected content. SAO 'report' on key risks and current state of controls provided to SAO by Tax Manager. Certificate submitted.

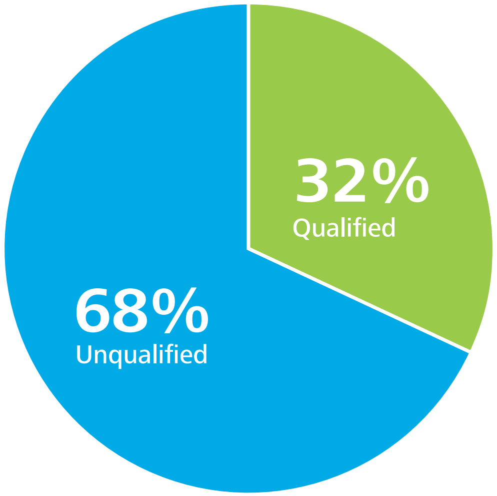
Certification: the story so far

Whatever the response to the rules, of the 1,600 or so businesses within the regime, all now should have submitted their first year certificate. We would expect HMRC to publish statistics in due course but our understanding is that approximately 30% of certificates to date have been qualified, i.e. they have confirmed that in at least one respect their "tax accounting arrangements" were not capable of calculating taxes accurately in all material respects. Indeed, of those that made such a disclosure, approximately half of them actually declared more than one issue.

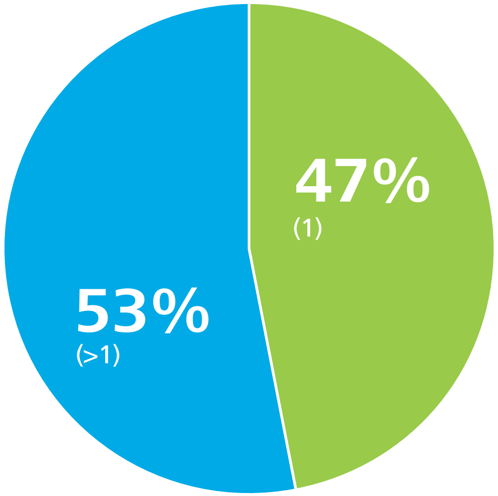
Even those companies which were not the subject of a disclosure will have their challenges and, in our experience, most will have recognised and reported to HMRC some kind of error under the company reporting procedures during the first year in the SAO regime, most often a voluntary disclosure for VAT purposes.

Submitting a clean certificate in these circumstances indicates that the SAO was comfortable that the error did not reflect a "material" gap in their tax accounting arrangements. Where companies have had these low-level errors the key challenge is ensuring these do not recur as HMRC's stated view is that repeated minor failings could be considered material over time.

Certificate status
Total population



Number of disclosures
Of the 32% who made a disclosure



Figures based on Deloitte data

And penalties? HMRC has confirmed that none have been levied to date but that consideration has been given in certain cases which have been identified by CRMs. This is perhaps not a surprise in respect of the 'main duty' requirement, given the first year 'light touch', but it is also encouraging that HMRC has to date been lenient in accepting late filings of year one certificates without raising penalties.

Areas resulting in disclosures

The nature of such disclosures varies from company to company and is clearly influenced by the scale of the business and the industry in which it operates. Some areas, however, appear to provide a consistent challenge and can lead to potentially significant issues:

VAT – Due to the transactional nature of indirect taxes, issues tend to arise more often within systems and processes outside the control of the tax team. Accuracy of the underlying data which leads to entries in the VAT return is a common issue for many businesses, with disclosures made in relation to the incorrect VAT coding of sales, purchases or intercompany transactions. These errors often affect low-value items but when repeated, may lead to a material total.

Insufficient documentation to support a tax technical position is another main area of risk and possible challenge by HMRC. This can arise in a number of areas such as self-billing, cross-border invoicing, or import/export documentation. Non-tax specialists are often unaware of the detailed documentation that must be produced and retained in order to either qualify for a particular VAT treatment or support a tax technical position.

Employment Taxes – Issues of inherent complexity such as short-term business visitors, termination payments or equity transactions continue to present challenges, especially if communication is not effective between all parts of the business that should be involved (HR, tax, reward, finance etc). Conversely, the most significant errors (in terms of quantum) can easily arise from more simple PAYE processing, such as operating incorrect PAYE codes.

Whatever the employment taxes risk or error is, the key to mitigating it (or not repeating it) is to put processes and controls in place that are appropriate to address the issue, and to continue to monitor the operation of these processes and controls. For example, if a risk has been identified concerning short-term business visitors and a measure has been implemented to correct it, then it will be important to assess the use and effectiveness of this control periodically. This is especially the case where fact patterns (and so tax and social security obligations) can change on a day to day basis, as is the case with short-term business visitors.

Customs & Excise duties – Issues can usually be grouped into two key areas. Firstly, lack of control over the activities of third party providers such as freight forwarders and clearing agents. Secondly, lack of sufficient control over processes to manage compliance requirements. This includes processes to manage the classification of goods, the determination of the value and origin of goods, as well as processes to manage reliefs from duty or special arrangements.

The focus for SAOs tends to be on the processes rather than individual transactions. Businesses which are not aware of the compliance obligations or which rely heavily on third parties to manage compliance are at the highest risk of errors or weaknesses. In one example, one company expected that the freight forwarder was an 'expert' in customs matters and did not realise that the forwarder was not accountable for errors. Once the company started to implement controls, it soon realised that the controls which had been in place at the forwarder had not been adequate to mitigate risks of non-compliance.

Corporate Tax – Corporate Tax issues tend to focus on three key areas. The first is understanding the nature of income and expense items in the P&L. Common areas of difficulty here could be entertaining or legal and professional fees but most groups appear comfortable that they are able to get sufficiently close to the 'right' answer. The bigger challenge is around large, one-off items.

For example, one group disclosed a significant error after relief had been claimed for a loan impairment that had been coded as an FX movement which the preparer of the return understood to be deductible. The finance team knew of the miscoding but a lack of regular communication meant that the tax team were unaware.

The second area is analysing fixed assets in sufficient detail to allow the tax team to make appropriate judgements. Often we find that a company's response to this is to be prudent, but in many cases they are not confident that they can even provide a suitable audit trail to defend the modest claims they have made.

The final common challenge is in respect of Transfer Pricing. In particular, challenges are around the implementation of arm's length pricing within the financial systems of the company, such as identifying accurately all costs that should be included within a mark-up calculation or correctly applying the chosen allocation key to determine recharges. For one group, the complexity of their arrangements, myriad true-ups and adjustments, and weaknesses in the spreadsheet model meant that a significant mis-statement of UK profits went undetected.

Looking forward
The new SAO environment

No more "light touch"

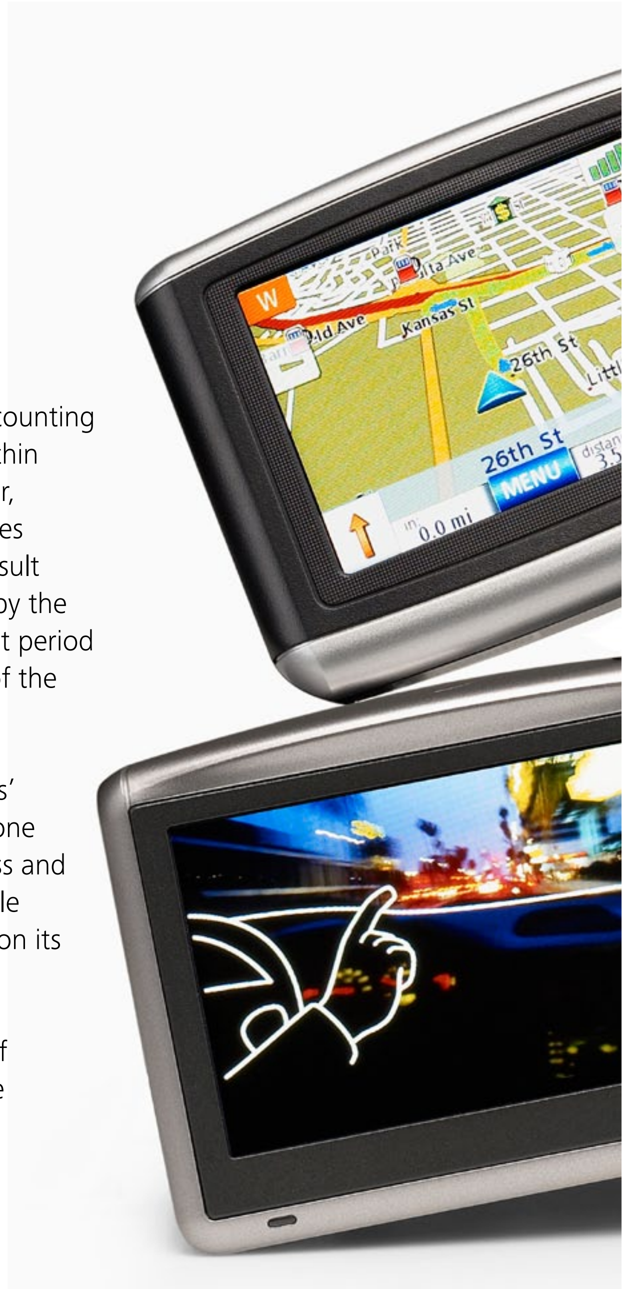
HMRC's initial guidance on SAO issued in 2009 introduced the concept of a "light touch" under which "...any SAO who begins a review of appropriateness of the tax accounting arrangements during the first financial year ....will be treated as having taken 'reasonable steps' in respect of that period..."(*Para 45, original SAO guidance*).

However, the guidance was very specific about its temporary nature, stating that "the 'light touch' approach will only apply to the first financial year after the introduction of the legislation. It will not apply to any later period even if a company only comes within the legislation for the first time within any subsequent year." (See subsequent qualification to the right)

Based on this definition, the last possible "light touch" accounting period would have ended in July 2011, so we are now within the full operation of the rules. HMRC have noted, however, that a "light touch" period will be applied to any companies that are brought within the scope of the SAO rules as a result of changes to HMRC policy that have been implemented by the new guidance. This "light touch" will apply only to the first period commencing after 26th April 2012 (the publication date of the new guidance.)

SAOs will now need to demonstrate that 'reasonable steps' have been taken to both address issues identified in year one and to maintain the company's tax controls as the business and relevant law changes. What actually constitutes 'reasonable steps' is for the company to decide, and will also depend on its circumstances.

Taking "reasonable steps" is not, however, a single one-off activity. It is a continuing responsibility that will need to be considered regularly to ensure adequate compliance.



Managing tax risk

In the revised guidance (see SAOG14410), HMRC give some helpful clarification, in particular suggesting that this might include establishing and maintaining processes within the tax accounting arrangements to:

- "ensure compliance with legal requirements.
- periodically check and test systems, controls, process flows and transactions.
- ensure that the introduction of new systems and processes, or changes to them, are supported by appropriate planning, risk assessment, implementation and evaluation activities.
- ensure the maintenance and retention of required records in whatever form.
- ensure staff and any third party to whom responsibilities are delegated are appropriately trained, have the necessary guidance, qualifications, knowledge and experience needed to carry out their functions.
- obtain relevant facts and advice to allow the company to make tax sensitive judgements."

For us, what this boils down to is ensuring that you have at least two, and ideally three, lines of defence in respect of each tax risk faced by the business:

- **First line of defence.** Much of the risk in relation to tax compliance depends on how a transaction is originally managed and recorded within the business. Often, however, the people making those decisions are not tax professionals but work in Finance, HR or elsewhere in the business. The first line of defence is often giving such people enough tax knowledge to make accurate decisions on common transactions and to encourage them to contact the tax department when something unusual arises.
- **Second line of defence.** Tax specialists can act as a second line of defence by setting policies, procedures and systems and then monitoring the results to ensure they are in line with expectations. This monitoring can be sample-based or could be more targeted, e.g. focusing on areas of the business that have recently undergone changes in systems.
- **Third line of defence.** Internal Auditors, when they exist, can provide a third line of defence through undertaking periodic testing of the effectiveness of both lines of defence and reporting to senior management.

How might this work in practice? The VAT return process

1st line of defence	2nd line of defence	3rd line of defence
Accounts Payable/ Receivable staff code transactions within their ERP system based on guidance set by Group Tax. Areas of uncertainty are directed to Group Finance and then Group Tax. Group Finance prepares the VAT return and undertakes standard exception reporting.	Group Tax defines guidance for staff engaged in tax compliance matters and provides input into set-up of ERP system. Group Tax addresses questions of uncertainty and undertakes analytical reviews of every VAT return. Group Tax trains Finance staff.	Internal Audit undertakes periodic testing of compliance with UK legislation and group policies and procedures. Report provided to senior management.

Iain McNeill, Deputy Director and Head of Risk in HMRC's Large Business Service, has suggested that there are a number of questions that SAOs should now be asking themselves when considering compliance with the legislation. These questions include:

- "How do you plan to maintain the assurance you've obtained following the introduction of SAO, as your organisation changes?
- Are there any particular areas where you have found it more difficult to get assurance?
- How active is consideration of SAO obligations at Board level?"

This list is not exhaustive but does provide a healthy challenge to SAOs and businesses alike and is well worth giving some consideration.

HMRC new guidance – more clarity, emerging difficulties

HMRC issued **new guidance** on the SAO regime on 26 April 2012. The revised guidance is helpful for SAOs and companies as it provides much more clarity on the operation of the rules.

HMRC have acknowledged three key shifts in policy with regard to SAO.

Firstly, the SAO rules are now expected to apply to companies in liquidation and HMRC will accept certificates with heavy caveats from SAOs that are liquidators. Secondly, banks and insurance companies will no longer be exempt from the turnover test to determine qualifying companies. Finally, HMRC are no longer of the view that UK incorporated companies that are non-UK resident will only be covered by the SAO legislation to the extent that they are trading in, or have some taxable activity in the UK (i.e. if a company is qualifying for SAO purposes, a certificate is required regardless of whether it has any UK taxable activity or not).

HMRC have confirmed that any company that is brought into the rules by these changes will benefit from a 'light touch' in the first year. HMRC have also confirmed that penalties will not be levied where companies and SAOs have followed previously released guidance for any period up to the first period commencing after the publication of this new guidance. Additionally, HMRC will not charge any penalties for previous periods where one would seem to be due under the previous guidance, but which would not be due under the latest guidance.

The new guidance provides more detail and greater clarity on the practical application of the legislation, particularly in some of the more complex situations. Areas of complexity arise in companies and groups that:

- have made acquisitions (see SAOG11300 through to SAOG11302)
- contain companies with non-coterminous year ends (see SAOG11290)
- are in liquidation (see SAOG12400 and SAOG16400)
- have been struck off (see SAOG15900) or
- have changed their SAO within the year (see SAOG12500 and SAOG15800).

The guidance also provides significant detail and clarification of how HMRC intend to operate the SAO penalty legislation (see SAOG18000 onwards). The guidance includes a number of examples of when penalties should and should not be applied by HMRC and indicates that there will be a strict process for CRMs and HMRC officers to follow when issuing SAO penalties.

Based on our experience, we understand that groups sometimes find it difficult to determine which companies fall within the legislation. A number of detailed examples in the new guidance help with this particular issue. However, this is not always straightforward, particularly in the case of non-coterminous year ends and mid-year acquisitions.

We would encourage groups to read the latest HMRC guidance and to consider whether any of the more complex examples apply. Identifying complications will be key to ensuring full compliance within the SAO legislation.

How does SAO interact with other UK tax compliance requirements?

It is important for SAOs and companies to be aware of the way in which the SAO rules and the actions that SAOs and companies take in response to them, may interact with other tax law and penalties and also the wider relationship with HMRC.

Penalties for incorrect tax returns

Incorrect tax returns can lead to penalties significantly greater than those imposed by SAO. Penalties range from 0 to 100% of the understated liability and are determined by considering the nature of the failure (from innocent error to failure to take reasonable care to deliberate misstatement with concealment) and whether its discovery was 'prompted' by HMRC activity or identified and disclosed by the taxpayer.

It is likely that HMRC will seek penalties for incorrect tax returns from more companies to which the SAO legislation applies than before. We expect that taking clear steps to identify and control their tax risks is an important part of SAO work.

In addition, such companies should normally be less likely to incur penalties for incorrect tax returns. These businesses should also have better control over their tax risks and so have fewer unexpected issues because they are better able to demonstrate that 'reasonable care' has been taken.

Where errors do arise, care should be taken over how these are disclosed to HMRC as there could be both implications for SAO purposes and penalties for incorrect tax returns. Whilst HMRC have stated in the new guidance (see SAOG23100) that it "does not regard the two [penalty regimes] as being automatically linked for penalty purposes", companies should nevertheless understand the possible effect that they may have on each other.

Emerging case law on penalties for incorrect tax returns, in particular on what constitutes 'reasonable care' in this context (and other key terms) may provide a useful insight into the standard of care expected of SAOs.

HMRC risk assessments

HMRC takes a risk-based approach to monitoring the compliance of large UK taxpayers. In classifying companies and groups as low or 'non-low' risk, the CRM will consider the nature of the business and its inherent tax risks and how well these are controlled through the business's approach to tax management, processes and systems.

HMRC have confirmed that qualification or otherwise of a certificate will not automatically lead to a higher or lower risk assessment but the information provided by the SAO in the certificate will form part of the evidence reviewed by the CRM in reaching their view.

Businesses which are better prepared to provide assurance to their SAO are more likely to be able to demonstrate to HMRC that they have the right policies, people and systems to deliver the right tax result. This should improve their chances of achieving a low-risk rating and so enjoy the lower compliance costs and greater certainty which are associated with this status.

CRMs should collect evidence to support the risk classifications of the companies or groups for which they are responsible. As a consequence, many are using discussions relating to SAO to justify requesting documentation which sets out the companies' approach to tax management (see the example). It's normally a good investment to prepare for such a request in order to be in a position to respond promptly.

For example, we have seen instances where SAOs are inclined to describe errors in tax accounting arrangements as 'one-offs' and so not a failure in processes or controls that should be disclosed for the purposes of SAO. However, when considering a possible penalty for incorrect tax returns in respect of such an error, suspension of that penalty may not be possible as such a suspension would typically require improvements and safeguards against the recurrence of the issue. This would be difficult if not impossible for a truly 'one-off' event.

"The ABC Group moved into low risk status at the formation of LBS. Since that time, HMRC definitions have changed and there is now a need for the CRM and team to have more formal evidence to substantiate their view of risk. *Documentary or observational evidence on the operation of SAO in real time* will provide a valuable insight on the company's corporate and operational governance and assist in this area. Provided the governance can be established and found satisfactory... I would expect the group to remain in the low risk population."

Extract from anonymised HMRC Risk Assessment

Ready, steady, sign

SAO does not override existing UK tax compliance requirements. It imposes obligations on an individual, admittedly a very senior one, and requires some additional high-level reporting. The new guidance provides more detail and clarity which should assist SAOs in their duties.

If SAOs are confident in the quality of their management of UK taxes it is unlikely that there is much more to do. If, however, SAOs are uncertain or want to check their processes then they should consider the extent to which they routinely undertake these steps:

Understand the business and its risks – There is a plethora of tax rules and regulations which can pose traps for the unwary. However, if SAOs have a clear understanding of their business (its products, markets, financing, operations etc) and have thought through the tax consequences of what it does then they know the key risks affecting UK tax compliance.

Control the risks – Once an SAO has a clear view of the risks faced by the business, the next step is to ensure that companies have appropriate controls in place, and that they are clearly operated in practice. The nature of the control will depend on the type of risk faced and the people expected to control it.

Monitor the controls – The monitoring of controls is the most significant part of the SAO's duties and an area which has been a challenge historically. Once controls are documented and allocated to an individual, it is far easier to verify that they work in theory and in practice. This activity should provide significant assurance to the SAO as it provides a second (and with Internal Audit, a third) line of defence against errors, as well as a way to identify issues to be addressed and disclosed.

Address issues promptly – Where issues are identified they should be evaluated and then addressed in order of priority. Like controls, such issues need to be clearly allocated to individuals if they are to work effectively; typically these would be key areas for future monitoring to ensure that the anticipated control has worked.

The cycle begins again – As time moves on so does business and tax law. In a fast-growing business affected by changes in tax law, the key risks a company had 12 months ago may no longer be valid. We would recommend that all businesses test their understanding of their risks periodically to ensure that resources are focused on operating and monitoring controls on the key risks to UK tax compliance.

None of this is new, but SAO introduces a structure and rigour that perhaps may have been lacking in the past. Now we see that risks are better understood and prioritised, responsibilities better defined, processes and controls more appropriately documented and review activity undertaken with greater regularity. The remaining challenge for SAOs will be to ensure that SAO principles are fully integrated within their businesses. Getting all this right should not only result in an SAO who is confident to sign their certificate, but also an organisation which is able to manage its own UK tax risks more efficiently and effectively.

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