



FOUR REASONS TO STRENGTHEN INCOME TAX ACCOUNTING INTERNAL CONTROLS

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As discussed in [Three Ways to Reduce Income Tax Reporting Risk](#), income tax-related restatements account for approximately 14% of all restatements. Additionally, in 2018, 81 SEC registrants cited a material weakness because of a tax issue. The reason behind weaknesses related to income tax may seem obvious: tax is inherently complex, changes in accounting guidance and tax law can be difficult to coordinate, most tax departments are understaffed, and income tax accounts for a significant portion of a company's financial statements. What we may not understand explicitly is whether these tax-related material weaknesses require remediation, but not a restatement. Regardless, the risk of not addressing material weaknesses could ultimately lead to a restatement, which can be very costly.

With the continued finding of material weaknesses, it is important for management to understand the overall burden the weakness places on the company, thus the need to strengthen internal controls related to income tax accounting. Despite being a focus of the Public Company Accounting Oversight Board (PCAOB) and public accounting firms, deficiencies in income tax accounting and internal controls continue to be a problem for many companies.

1. CONSULTING FEES

The direct cost of remediating a material weakness, with or without a restatement, can be particularly burdensome on an organization. Costs incurred often include:

- ▶ Third-party advisors to assist in the development and execution of the remediation plan, including the training of process and control owners
- ▶ Additional audit fees for enhanced testing procedures
- ▶ Remediation monitoring and auditing of restated financial statements
- ▶ Legal fees to assist in any pending actions taken and additional oversight of communications

The costs may not be insignificant. For example, in recent years, a Houston-based public company disclosed income tax remediation expenses in excess of \$170 million and additional governmental fines of \$140 million. While not all remediations come with such a significant price tag, any costs incurred may have significant financial and operational impact to the company.

2. INVESTOR CONFIDENCE AND MARKET CAPITALIZATION

A material weakness can spark worries from investors about reduced future performance due to significant remediation costs, doubt related to other areas of the financial statements, and questions related to management of the organization. Regardless of their validity, investor concerns are often demonstrated through a drop in stock price. A well-known brewing company reported that its stock "tumbled" following its material weakness disclosure related to income tax. The Houston-based company mentioned previously realized a more than 10% drop in stock pricing following its first restatement. With possible drops in stock price that could be caused by restatements, the impact on market capitalization for any given company could be in the billions.

3. RESOURCE CAPACITY

An internal tax department with ample resources available to accurately address controls issues is a rarity. With already-strained resources, focusing on a remediation and/or a restatement of a past event is not a value-added use of those resources. Capacity within the tax department (or any other department involved) could be more effectively used to generate cost-saving ideas, improve and streamline processes, and focus on managing risk and delivering value.

4. REPUTATIONAL RISK

Possibly the most significant and difficult burden to measure is the impact to an organization's reputation, as well as the reputation of its management team, that comes from being associated with a material weakness.

The Sarbanes-Oxley (SOX) Act, intended to protect investors from accounting errors and fraudulent financial reporting, requires the establishment of internal controls and reporting methods created to ensure those controls. Corporations often view SOX compliance as onerous and expensive; however, the cost and effort to remediate can be far more expensive than the cost to implement and execute strong controls.

In addition to leaving your company better prepared for the provision of income taxes, proper internal controls will allow your tax department to increase operational accuracy and be a strategic driver of revenue. As most companies continue to persevere through the COVID-19 pandemic, the ability to decrease costs and reduce risk will help keep investors satisfied.

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