

Tax Control Framework

From a focus on risks to being in control: a different approach

*Netherlands Tax and Customs Administration
Co-ordination group on the treatment of very large
businesses
TCF Working Group
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Contents

Foreword 3

1. **Introduction 4**
2. **International developments in Corporate Governance 5**
3. **(Horizontal) monitoring 7**
 - 3.1. Why horizontal monitoring 7
 - 3.2. Horizontal monitoring and compliance covenants 7
 - 3.3. Transparency, understanding and trust 8
4. **Client processing, covenants and TCFs 10**
 - 4.1. ZGO policy plan; extent to which a client is in control determines the form and intensiveness of monitoring 10
 - 4.2. Areas of focus in our monitoring 10
 - 4.3. Monitoring of covenant clients 10
 - 4.4. The TCF als prime focus of our monitoring 11
 - 4.5. Materiality 12
 - 4.5.1. *The meaning of materiality 12*
 - 4.5.2. *The level of materiality 13*
 - 4.5.3. *Engaging experts 14*
 - 4.5.4. *Brief summary 14*
 - 4.6. Cooperation in a multidisciplinary processing team and the client coordinator 14
5. **How do I go about discussing a TCF? 16**
 - 5.1. Introduction 16
 - 5.2. Levers of Control 16
 - 5.3. Relationship between levers of control and COSO 17
6. **COSO 18**
 - 6.1. The importance of COSO for a TCF 18
 - 6.2. COSO as standard 18
 - 6.3. COSO Internal Control - Integrated Framework 19
 - 6.4. COSO Enterprise Risk Management - Integrated Framework 20
7. **What does this mean for my work? 22**
8. **Experiences with businesses to date 25**
 - 8.1. General 25
 - 8.2. The Netherlands Tax and Customs Administration 25
 - 8.3. Set-up 26
 - 8.4. Other pilot project experiences 26
 - 8.5. Belief systems 27
 - 8.6. Boundary systems 27
 - 8.7. Diagnostic control system 29
 - 8.8. Interactive control systems 30
 - 8.9. Recapitulation 31

9.	Components of internal control and of enterprise risk management according to COSO	32
9.1.	Components of internal control (COSO, 1992)	32
9.2.	Components of enterprise risk management (COSO, 2004)	33
10.	Literature	34

Foreword

This memorandum is about tax control frameworks (TCFs) and is intended for all technical staff and managers of Very Large Businesses ('ZGOs'). Do not expect any minimum requirements for TCFs. Nor is this possible. A TCF forms part of a business control framework, which is different for every business. The fact is both are tailor-made. We share our experience gathered from discussions with a number of multinationals about their own TCFs. We also provide background material that will help you discuss TCFs with businesses and we examine the most widely used internal control model, the COSO framework. Always remember that a business makes a TCF for itself, not for us. The most important message of this memorandum is that your work is going to change. It will focus more and more on assessing business processes, the degree of control businesses have over their processes and the way in which they articulate the critical junctures in them as regards tax, linking prescribed working methods to these and ensuring internal and/or external control. We examine all this in detail in order to assist you in pursuing this approach. But that's not all. This year we are organising day-courses in tax assurance for tax officers. The summer courses for accountants will be to a large extent devoted to this subject. Both groups will come together on the tax assurance sessions at the end of the year. Crucial to this development is that we work together in the various disciplines involved. Only then can we make a success of the new approach. With this memorandum I invite you to go ahead and enter into dialogue with the ZGOS about how we intend monitoring and the relevant role of tax control frameworks. It is important that you share your experiences, both with one another and in the intervision due to begin in 2008 regarding the implementation of the ZGO Policy Plan. If you have any questions, you can talk to colleagues who have carried out the tax control framework pilot project and who continue to play an important part in its further development, ie, Conny Beaufort-Out (Amsterdam), Kees Buitenhuis (Rijnmond), Hans Rijsbergen (Rijnmond), Dike Sialino-Keen (Rivierenland), Robbert Veldhuizen (Utrecht-Gooi), Gerrie Verschuren (Amsterdam), Peter Waas (Rijnmond) and Hans van Wezep (Amsterdam).

Edwin Visser

Chair of the Co-ordination Group on the treatment of Very Large Businesses

1. Introduction

“I would also like to emphasise that the main basic premise is that enforcement covenants are concluded with businesses whose tax control frameworks are solid, shaped by IFRS standards and the United States Sarbanes-Oxley Act.”¹

With this statement the state secretary for Finance introduced the term tax control framework (TCF) into Dutch tax jargon. It made TCFs an explicit issue in dealing with ZGO clients. But what is a TCF? It is an internal control instrument that focuses specifically on a business's tax processes. These are not necessarily restricted to the tax department. A TCF forms an integral part of a company's Business or Internal Control Framework (ICF). In this examination we use the term tax control framework to refer to elements of an ICF that are relevant to tax, the term 'tax' covering all types of tax. One particular objective of the ZGO Policy Plan 2007-2010² (ie, ZGO Policy Plan) is that the Co-ordination group for Very Large Businesses investigates how businesses should set up a TCF and develop their own vision about its minimum quality requirements. Not intended are generic minimum requirements. A TCF forms part of an ICF. The set-up of an ICF, and therefore a TCF, is different for each business and is shaped by any number of factors, eg, size, complexity, structure of the business. It is, however, possible to offer guidelines for establishing a TCF. To this end a pilot project has been launched, in which discussions have been and still are being conducted with a number of businesses (ZGOs) about the set-up of a TCF. Results of it are included in this memorandum.

This memorandum will be modified in line with our experiences with one another in practice. Share your experiences with one another, in the intervision and with the colleagues listed in the foreword who carried out the pilot project. Do this not only to increase our knowledge, but also to achieve consistency in our work in this area.

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¹ Letter dated 9 June 2006 to the Chair of the Senate [*Eerste Kamer*] of the States General from the State Secretary of Finance, No DGB06-3312

² ZGO Policy Plan 2007-2011, p. 20

2. International developments in Corporate Governance

Since the beginning of the nineteen nineties a number of leading corporations have run into problems because their internal and external control systems functioned inadequately. In response a considerable number of corporate governance codes and laws were drafted and enacted. Governments in various countries took measures, including the United States, which implemented the Sarbanes-Oxley Act³ (SOx). This act imposes stringent requirements on executive boards of businesses listed in the United States, including Dutch ones. The Securities and Exchange Commission (SEC) supervises compliance with SOx and issues rulings interpreting the act. The aim of SOx is to recover public confidence in the business sector and the accountancy profession. In the Netherlands the Tabaksblat Committee developed the Netherlands Corporate Governance Code⁴, which imposes strict requirements on executive boards of businesses listed in the Netherlands. Businesses do not have to observe the Code in its entirety. The code does, however, require that businesses provide an explanation whenever they do not comply fully with it. An important provision of both SOx and Netherlands Corporate Governance Code is that the management of a business must make a statement about the business's internal control. This it does with an 'in control statement' in its annual report.

In order to be able to issue a control statement, a business needs to have implemented a Business or Internal Control Framework. The Internal Control – Integrated Framework commissioned by COSO⁵ has more or less become a standard among businesses (see chapter 6).

The importance of the tax element in controlling the risks of a business's internal processes is increasing. This is evidenced by the appearance of new legislation (national *and* international) laying down rules about tax processes and what is required of management, supervisors and financial

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³ The Sarbanes-Oxley Act, dated July 30, 2002 (Pub. L. No. 107-204, 116 Stat. 745, also known as the Public Company Accounting Reform and Investor Protection Act van 2002,

⁴ Netherlands Corporate Governance Code. On 30 December 2004 the Code was designated a code of conduct with the meaning of section 2:391 (4) of the Dutch Civil Code (CC) (Netherlands Bulletin of Acts and Decrees [*Staatsblad*] 2004, 747), which gave the Code statutory status.

⁵ Committee of Sponsoring Organisations of the Treadway Commission. A voluntary private sector organisation dedicated to improving the quality of financial reporting through business ethics, effective internal controls and corporate governance.
www.coso.org

authorities (eg, the AFM, the Netherlands Authority for the Financial Markets)⁶.

These developments are creating opportunities for the Netherlands Tax and Customs Administration to align its operations to them.

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⁶ International Accounting Standards 12, Accounting for taxes on income forms part of the IFRS (International Financial Reporting Standards). The IFRS has since 1 January 2005 applied to all ZGOs listed in the Netherlands. FIN 48 Accounting for Uncertainty in Income Taxes (interpretation of FASB-statement 109 Accounting for Income Taxes) applies to ZGOs listed in the US. Unlisted ZGOs must report on taxes in accordance with the RJ 272 of the Netherlands Annual Reports Council [*Nederlandse Raad voor de Jaarverslaggeving*]. In addition, more general guidelines are also given. See for example section III.54 (e) of the Netherlands Corporate Governance Code, which states that the auditing committee of a Supervisory Board must supervise 'the tax planning policy of the company'. The AFM (Netherlands Authority for the Financial Markets) has also announced it will expressly examine the tax paragraph in the annual reports for 2006. These examples make clear that tax processes constitute an important part of good corporate management.

3. Horizontal monitoring

3.1. Why horizontal monitoring?

Digging around for data in previous tax years has always been unsatisfactory for businesses as well as the Tax and Customs Administration, one of whose objectives is to work as much as possible in the here-and-now. Extreme positions have sometimes been taken in tax conflicts. Little trust existed between the two sides, meaning that little information was shared. Resolving conflicts was a long drawn-out process, resulting in high costs for both parties. And this, in turn, was not exactly conducive to compliance, whereas that is one of the chief objectives of the Tax and Customs Administration.

In order to achieve its objectives, the Tax and Customs Administration has introduced horizontal monitoring⁷. This entails mutual trust between the taxpayer and the Tax and Customs Administration and clearer communication about each other's responsibilities and capabilities in order to do what is right, as well as laying down and observing reciprocal agreements. Horizontal monitoring is in line with developments in society, where the individual responsibilities of corporate and government managers and administrators are defined more clearly and upheld through supervision. Businesses must be transparent for stakeholders about the degree to they achieve operational targets and the extent to which they are in control of the processes involved. The government is an example of a stakeholder.

3.2. Horizontal monitoring and compliance covenants

The principles of a compliance covenant are mutual trust, understanding and transparency.

A compliance covenant establishes the method and intensiveness of monitoring by laying down agreements on collaboration between the parties. The opening lines of the model text of a compliance covenant - as published by the State Secretary - contain the following:

"The parties will endeavour to establish an effective and efficient approach based on transparency, understanding and trust. They will endeavour to create a sustained understanding of ongoing tax risks and rapidly establish up-to-date positions on them under the dictates of law, regulations and case law in order to improve legal certainty."

Because trust plays a pivotal role in horizontal monitoring, the Tax and Customs Administration has decided to limit the amount of text contained in a compliance covenant. It is principally a mutual declaration of intent about how the parties wish to relate to one another. The intentions are detailed in a number of specific agreements about businesses reporting (significant) tax

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⁷ Letter from the State Secretary to the Dutch House of Representatives [*Tweede Kamer*] about Horizontal Supervision and mediation, dated 8 April 2005, no. DGB 2005-01109

risks and the Tax and Customs Administration providing certainty in advance about such risks. A compliance covenant also contains agreements about the way in which pending cases and the past are dealt with. It is important that past matters are resolved. It helps build on a relationship of trust. A special aspect of compliance covenants is that businesses and the Tax and Customs Administration conclude them voluntarily. At issue is not so much the agreements laid down in black and white, but very much more so the attitude both parties adopt towards one another as well as their conduct.

In a system of horizontal monitoring, such as the one used by the Tax and Customs Administration, there is also room for monitoring by the Tax and Customs Administration itself. A basic premise of it is that the Tax and Customs Administration does not do any work that has already been done by others (ie, internal and/or external auditors). The onion-skin model ('schillenmodel'), as described in the Tax and Customs Administration Audit Approach (hereinafter 'CAB') shows how this model works. The object of monitoring is the TCF, because it describes the business's system for controlling tax processes.

3.3. Transparency, understanding and trust

For the Tax and Customs Administration trust means "the expectation that the other party will conduct itself well". A compliance covenant is the foundation stone provided by the Tax and Customs Administration for building on trust.

Working from the premise of trust does *not* mean that the Tax and Customs Administration assumes that taxpayers make no mistakes. It does mean, however, that the Tax and Customs Administration expects the taxpayer to display good conduct. If this expectation is borne out in practice (transparency), then trust grows. If, however, a taxpayer's conduct does not meet this expectation, then an appropriate response is called for. This means in the first place that the conduct should be understood before we respond. In determining our response, we need information about the causes. If the Tax and Customs Administration expects good conduct and promises to respond appropriately and with understanding, a taxpayer trusts that it can be open and transparent. This is what we wish to accomplish with a compliance covenant, because maximum transparency minimises compliance costs for all parties. The central objective (compliance) and the permanent responsibility of the Tax and Customs Administration (executing laws and regulations effectively and efficiently) can thus be achieved. Transparency, understanding and trust are reciprocal in the relationship between taxpayer and the Tax and Customs Administration. Therefore the Tax and Customs Administration must also be open and transparent about its conduct. Examples of this are sharing the client profile with the business, keeping promises to take decisions rapidly, and working to private sector time scales. The Tax and Customs Administration also assumes that a taxpayer will respond appropriately (ie, with understanding) to conduct on the part of the Tax and Customs Administration even if due to policy or knock-on effects such conduct is unfavourable for the business in question.

Trust and control are not mutually exclusive. As remarked above, trust grows when parties coordinate with each other from time to time or they understand one another (transparency), give attention to one another

(understanding) and report to one another. Excessive control, or even the refusal to allow control, feeds mistrust. Relationships develop through meeting, working together and gaining experience (van Amelsvoort, 2007).

Trust can be damaged if the conduct of individual staff is subject to insufficient monitoring or control (Nooteboom, 2004). Thus, the degree of trust is also influenced by the extent to which a business and also the Tax and Customs Administration are in control. Trust can also be damaged in the event that either the Tax and Customs Administration or businesses give their staff too little support in carrying out responsibilities and performing agreements. Internal control systems provide clarity about who is responsible and accountable for what. Thus a TCF, as part of an internal control system, plays a crucial role in building up and strengthening trust between a business and the Tax and Customs Administration.

4. Client processing, covenants and TCFs

4.1. ZGO policy plan; extent to which a client is in control determines the form and intensiveness of monitoring

An up-to-date client profile of a ZGO gives an idea of the extent to which the client is in control and the degree of compliance. The extent to which the client is in control very much determines the form and intensiveness of monitoring. The ultimate goal is to create a situation in which one can simply assume that the client's tax return is acceptable. To achieve this, we also make use of the work already done by third parties.

4.2. Areas of focus in our monitoring

Using the approach laid down in the ZGO policy plan, of which the strategic processing plan is key, the following principal areas of focus ('monitoring objects') can be distinguished for all ZGOs (ie, including ones with which no covenant exists):

- internal control, the TCF
- preliminary discussions
- the tax returns.

4.3. Monitoring of a covenant partner

A compliance covenant establishes that businesses submit to the Tax and Customs Administration current or impending tax positions of any importance that may allow differing interpretations. Part of the agreement is that the Tax and Customs Administration takes a decision on this quickly. Through preliminary discussions on this matter, the Tax and Customs Administration tax specialists and the ZGO have a good deal of contact with one another. They discuss the tax positions and assess their consequences for tax purposes. The tax return is filled out with due observance of the agreements made in the preliminary discussions. The tax positions to be reported and the tax returns are the output of various tax processes within the business. The extent to which the business is in control of these processes is an important factor predicting the quality of the output of these processes. It is therefore important that the Tax and Customs Administration forms an impression of what a business does in order to control its tax processes.

The extent to which a ZGO is in control determines to a large degree the form and intensiveness of monitoring. This therefore means that the Tax and Customs Administration must have an understanding of the design, occurrence and operating effectiveness of the TCF. We want to find out whether the TCF is good enough to provide reliable information (ie, tax positions and returns). If a TCF is solid and in line with the agreements laid down in the covenant, and the positions reported have been discussed, then the return will only be monitored to a very limited extent or even be a mere formality. In determining whether the TCF is solid, the Tax and Customs Administration will rely where possible on work that has already been

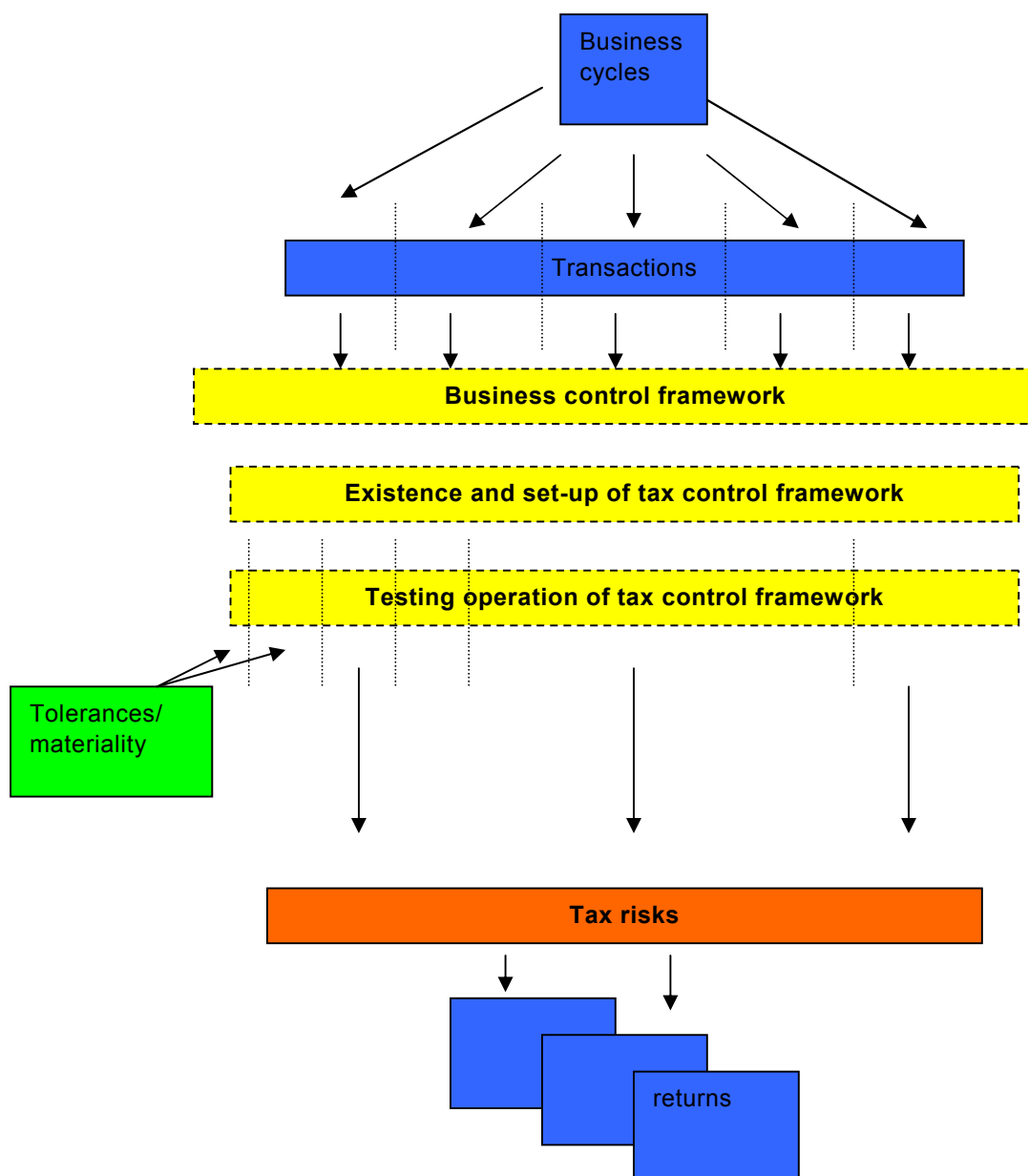
carried out.

If monitoring brings to light past failings, then the causes of them should first be investigated. The mistakes must be corrected for the past. The causes of these mistakes should be discussed with the management. If mistakes are the result of defects in the TCF, then we will talk about possible modifications to the TCF. In doing so we must realise that not every mistake can or must be prevented. The prevention of every possible mistake is disproportionately costly and is not necessary in the theory of materiality (see section 4.5). By pursuing this approach, monitoring in arrears has an effect on the future in terms of maintaining and strengthening compliance.

4.4. The TCF as prime focus of our monitoring

The object of a TCF is to control a business's entire set of tax processes: corporate income tax, import and excise duties, wage tax and national insurance contributions, regulatory energy tax, VAT, tax on games of chance, environmental taxes, tax on air travel, tax on packaging materials, private motor vehicle and motorcycle tax. In addition, correct and timely payment of them all obviously fall within the scope of a TCF. Tax plays a role in practically all business processes. Examples are the provision of collection information such as statements on wage tax and national insurance contributions and bank information. The conclusion of a sale transaction (full accounting for revenue) and issuing of invoices (creation of 'valuable papers') are tax products that are generated in the primary process. Aside from the above, tax strategy is regarded more and more as the responsibility of management at the highest level. Thus, tax processes manifest themselves in a business at the strategic, tactical and operational levels and as a staff department whose core activities are tax financial reporting, tax risk management, tax planning and tax cost management.

Until recently our work often concentrated directly on tax risks perceived by us. Looking at the diagram given below, we began at the bottom. However, we wish to focus on an assessment of the design, occurrence and operating effectiveness of a TCF. Looking at the diagram below again, we begin by trying to understand the business according to the Tax and Customs Administration audit approach ('CAB'). We then examine whether and how tax-critical moments in the business cycles are controlled. We assess the design and occurrence of the TCF (see chapters 5 to 8). Ultimately we also have to establish the operating effectiveness of the TCF, ie, do the controls work? Degree of detail in the provision of information (ie, materiality) in testing requires discussion with the business itself (see section 4.5). In determining the operating effectiveness of the TCF, we obviously build on work already done by third parties, eg, the external accountant, tax auditor, internal auditor, tax department etc (the onion-skin model); important here is to determine whether the business has drawn on tax expertise and, if so, to what extent. In doing so we also work together with various disciplines. The number of tax risks will decrease as internal control improves. With covenant partners we discuss tax aspects requiring attention at the moment they arise in the organisation. This will spare us having to devote much if any time to the return: the fact is that the work will have been done by the time we receive it. With non-covenant partners we discuss the tax risks at the moment the taxpayer wants preliminary discussions or once it has filed its return.



4.5. Materiality

4.5.1. The meaning of materiality

When you consider the costs involved not every mistake can be avoided. Important, though, is that not too many mistakes go unnoticed. Here the terms reliability and materiality are used in practice.

Materiality is the quantitative norm (expressed in a sum of money) that is necessary to determine when a population subject to auditing is good enough. This is the case if the sum of the mistakes does not exceed this

sum of money⁸. Materiality thus serves as an approval boundary for auditing⁹. By that materiality is an important parameter for determining the amount of work that must be done to find out whether the norm of good enough has been met sufficiently.

Another important parameter in this context is reliability. This concept is connected to the probability that the sum of mistakes exceeds the materiality without being noticed. Accountants generally reckon on 5%; in that case reliability is said to be 95%.

Assuming a materiality of say 100,000, a population of say 10,000,000 and a reliability factor of 95%, the term materiality covers the statement: "If in a sum of 10,000,000 due to be monitored in this population a sum of (more than) 100,000 would be in error, then it must be discovered in at least 95 out of the 100 (random) inspections." The words, "If ... would be in error" indicate that the foregoing does not therefore mean that 5 out of the 100 populations contain errors (following inspection) as large as the materiality (or larger). Not all populations subject to monitoring will after all have errors up to such an amount.

It is important to realise that in principle materiality applies to all transactions in a certain period considered together. Thus one cannot say per transaction that this is not relevant (material) because of the minor amount of the transaction. The fact is that many such transactions considered together can represent a material interest¹⁰.

Finally, it is important that when the findings are evaluated, not only the amount but also the nature of the observed errors (a qualitative norm) influence the ultimate assessment¹¹.

4.5.2. The level of materiality

For businesses that need an (unqualified) opinion on the financial statements (annual accounts), the materiality observed by the Tax and Customs Administration will generally be lower than the materiality observed by an external account when auditing the annual accounts. Materiality for the annual accounts for tax purposes is often felt to be too high. This is not, however, only the case for tax purposes.

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⁸ It is therefore not a correction boundary. A correction boundary is an amount below which no corrections are made for all sorts of reasons, including ones of efficiency.

⁹ Monitoring in this section can refer to internal (specific) and external (annual accounts or tax) monitoring. The population subject to assessment or monitoring is formed by all transactions in a financial year, which must be assessed as to their accuracy and go towards forming the basis for the annual accounts and/or tax returns.

¹⁰ For instance, a South American bank became insolvent in 1995 when neither internal nor external checks bothered about minor transactions, while these transactions were used for large-scale fraud.

¹¹ For instance, signs indicating a breach of internal control measures by management ("tone at the top") or fraud will generally result in further investigation, regardless of the extent of the irregularities.

Internal controllers of business processes also feel that materiality is too high for the audit of annual accounts. This means that a company often takes a lower materiality for planning (internal) auditing activities. It is logical that in making agreements about materiality we should align ourselves to this – lower – materiality. The fact is that this has a direct relationship with the degree of “control” that a company endeavours to achieve internally.

This does not, however, mean that the materiality agreed on by an organisation is or must be the same as the materiality observed by the Tax and Customs Administration. A lower degree of materiality means that more substantive procedures must be performed. Depending on the findings on the quality of the internal control and checking systems and the quality of the audit work already carried out, one determines whether such work focusing on actual data should be done.

Finally it should be noted that the random sample method employed by the Tax and Customs Administration means that all transactions greater than two thirds of the materiality are always monitored. This can be observed as the norm for the quantitative part of the question which transactions one should report.

4.5.3. Engaging experts

It is advisable to consult (sampling) experts if concrete agreements are made about the degree of materiality and/or the set-up of monitoring in order to determine whether the (tax) control framework is adequate and effective ie, “good enough”.

4.5.4. Brief summary

On the whole it may be said that the use of materiality (as an element of statistical scientifically criteria) means that monitoring is made objective and transparent:

1. materiality is a means of establishing the quantitative norm “good enough;
2. “materiality ultimately determines how intensive monitoring should be;
3. the degree of intensiveness of monitoring is – given the materiality – objectified (and fishing expeditions are prevented under these circumstances);
4. the business in question will itself be able – assuming the norm “good enough” – to assess whether it meets the norm;
5. aside from a quantitative aspect, materiality includes a qualitative one.

4.6. Cooperation in a multidisciplinary processing team and the client coordinator

The processing team already includes staff from various disciplines. The importance of working together in a managed way assumes greater importance as the assessment of TCFs becomes more important. Because TCFs are becoming more essential we also see in ZGOs that tax specialists have started working more and more with accountants and internal or external auditors. The Tax and Customs Administration will have to see to it that it provides fully qualified and experienced personnel to talk to these experts. It is therefore necessary to that cooperation with the Tax and Customs Administration between auditors and tax specialists is intensified.

Accountants and auditors (operational/IT/statistical) are experts on internal control. Because the crux of the matter is internal control of tax processes, tax expertise, which can be provided by specialists in all types of taxation, is also necessary.

The client coordinator plays a coordinating role in the processing team. Part of the ZGO policy plan includes the objective to professionalise the role of client coordinator in horizontal monitoring. While the current emphasis often lies on the client coordinator's internal role (manager of the file), it should in the near future be shifted to his or her external role (ie, contact for the ZGO). The client coordinator manages the client profile, of which the TCF is an important part.

5. How do I go about discussing a TCF?

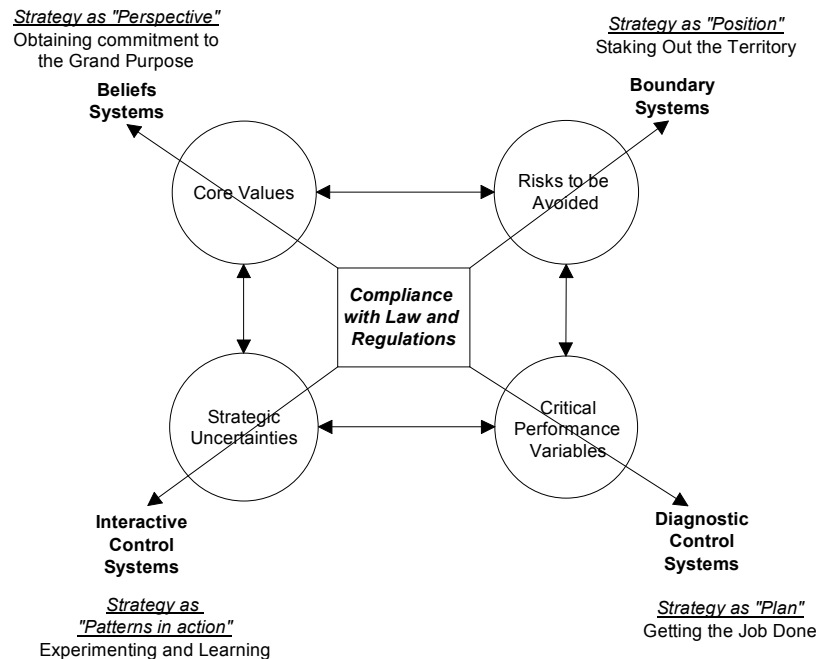
5.1. Introduction

In de TCF pilot project discussions were held with businesses about the set-up of their TCF.

In assessing the design of a TCF, the Tax and Customs Administration's pilot project pursued the lines of a conceptual model, the "Levers of Control" (Simons, 1995). This model provides a rapid understanding of the various facets of a TCF and enables a discussion to be structured well. Its usefulness was demonstrated in discussions with managers and representatives of the tax departments involved in the pilot project. Through the model's levers you automatically enter into a discussion about the application of COSO-ERM, the most often used internal risk control model.

5.2. Levers of Control

Simons' 'Levers of Control' model is as follows.



The levers are joined to one another through the central objective of compliance. In Simons' definition, the levers of control are formed by the boundary systems and diagnostic control systems. The boundary systems establish the norms (based on values from the belief systems). The diagnostic control systems provide the command and control mechanism for executing the business processes in accordance with the established norm. The interactive control systems provide room for experimenting and learning. They also focus on changes that may affect the accomplishment of strategic objectives.

Within the concept of horizontal monitoring, both the business and the Tax and Customs Administration have in principle a common objective, ie, compliance. It is good to make the meaning of compliance the subject of a discussion, because perceptions may differ. The levers of control make clear what control system can be implemented within the enterprise in order to accomplish this objective. The four levers together give an idea of the extent to which a business is in control. Below, for each control system, is a description in a few short sentences of what a TCF may include. The belief and boundary systems together form the so-called 'soft controls'. The diagnostic and interactive control systems form the so-called 'hard controls'.

- Belief Systems:

The belief systems are the values of the business. Examples are the meeting legislative requirements, integrity, ethics, etc. Management (Executive Board, Supervisory Board) must actively project these values and display exemplary conduct. This we call 'tone at the top'. Important aspects here are the activities, communication and conduct of management. What does management do to ensure proper and seemly conduct by employees?

- Boundary Systems:

What concrete norms are laid down based on a business's values and strategic objective? Are the Supervisory Board, Audit Committee, tax department and internal auditing department aware of these norms? Are lower management and other employees aware of these norms? How are the norms communicated? Norms may include laws and regulations, internal guidelines and even performance indicators.

- Diagnostic Control Systems:

What internal control measures have been taken in order to ensure that the norms are observed so that tax processes are conducted smoothly and are under control? What kind of audit trail does this create, and is it preserved? What internal control measures are necessary for the tax department to be in control?

- Interactive Control Systems

- Involved here is the control of non-routine processes and the way in which changes in circumstances are anticipated. Questions asked in this context are how the control framework is safeguarded such that amendments to laws and regulations are implemented and complied with. How are transactions outside the primary processes, many of them occurring at low frequency and therefore not as a matter of course, recorded accurately and fully and thus kept in control? How are the tax consequences of seized opportunities and averted threats controlled?

5.3. Relationship between levers of control and COSO

Frequently used is the COSO's Internal Control Framework. Publications by the four largest consultancy firms also refer to this model. It is logical that this model should be chosen. The fact is that a TCF forms an integral part of the Business Control Framework (BCF) and, in order to set up a BCF, COSO is an important standard.

COSO is an instrumentally normative model. It includes regulations for setting up an internal control process, thus making the open norm explicit. The theory of internal control and information control applies to the boundary systems and diagnostic control systems. COSO can be drawn upon for describing these systems (see chapter 6).

6. COSO

6.1. The importance of COSO for a TCF

Most listed ZGOs use the COSO model to set up an ICF. Because a TCF is an integral part of an ICF, knowledge of COSO is important in order to understand the TCFs of these companies. This chapter first examines the references that have made COSO a de facto standard. It then explains the principles of the Internal Control Framework.

6.2. COSO as standard

As stated earlier, COSO has become a standard because legislation and corporate governance codes frequently refer to this model. For the Netherlands, the most important references are in the Auditing Standards 2 and 5 of the Public Company Accounting Oversight Board (PCAOB) in the United States and in the Netherlands Corporate Governance Code. Below is a brief explanation of both the auditing standards of the PCAOB and the Netherlands Corporate Governance Code.

PCAOB

The PCAOB was established following the enactment of the United States Sarbanes-Oxley Act (SOx) (January 2002). SOx prescribes among other things that businesses must declare from time to time that their financial reporting process is in control, doing so by means of an In Control Statement (SOx section 302). A public accountant must issue a statement in conjunction with this (SOx section 404). Pursuant to the SOx, the PCAOB is responsible for supervising the quality of the public accountant's audit (in the Netherlands the AFM has this responsibility) and issuing guidelines of carrying out this audit. These guidelines are published in the form of Auditing Standards which public accountants must observe when auditing the annual accounts of businesses falling under the SOx regime.

Important auditing standards are:

AS2 (2004): an audit of internal control over financial reporting performed in conjunction with an audit of financial statements

AS5 (2007): an audit of internal control over financial reporting that is integrated with an audit of financial statements

Both AS2 and AS5 refer to COSO as an appropriate framework for setting up an ICF in a business.

Netherlands Corporate Governance Code

In section II.1.4. of the code the Tabaksblat Committee writes: "It is logical that in the statement about internal risk control systems and control systems the executive board indicates what framework or system of norms (such as the COSO internal control framework) it used in evaluating the internal risk control and control systems. (Corporate Governance Committee, 2003)

This reference means that listed enterprises in the Netherlands that do not fall under the SOx regime take COSO as a framework for setting up their Business Control Framework.

6.3. COSO Internal Control - Integrated Framework

COSO's "Internal Control - Integrated Framework" defines the term internal control, describes components and gives criteria that can be used for assessing and improving control systems. An important tenet of COSO is that internal control will be set up based on business processes. This is also highly relevant to the Tax and Customs Administration's work: understanding the ICF of a business begins with an acquaintance and understanding of its business processes.

COSO defines internal control as follows:

"Internal control is 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
- Compliance with applicable laws and regulations."

These categories are the first dimension of the COSO cube (see below).

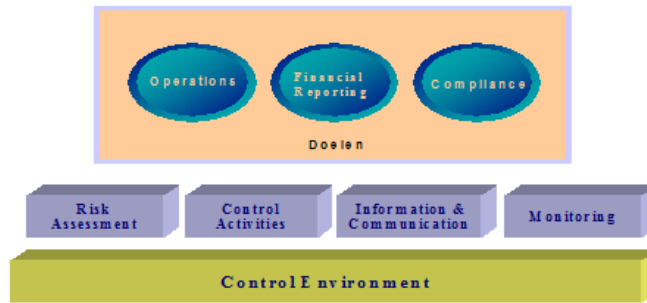
The process of internal control comprises five components, which form the second dimension of the COSO cube.

The first three components are activities that are carried out per business process. The last two support the first three. The components are:

- risk assessment:
determining the inherent (tax) risk of a process. An inherent risk is a risk as regards the operation of any internal control measures that are in place;
- control activities:
designing, implementing and executing (set-up, existence and operation) of key controls with the aim of controlling the inherent risks in the process. These controls are the separation of processes, information control, physical control and performance assessment;
- information and communication:
providing management information for assessing the extent to which goals are achieved and communicating about the internal control system, so that those working for the business know what is expected of them;
- monitoring:
monitoring the quality of the internal control system and
- control environment
the foundation of an internal control system. This includes the integrity, ethics and competences of the organisation and its members.

For a detailed description in English of the above components, see chapter 9.

The components together comprise the COSO internal control process. Their purpose is to achieve the goals laid down. The following diagram indicates how they are correlated:



COSO brings together the goals and components of internal control in a cube. Each side of the cube shows that the goals and components apply to all divisions of the company. The divisions of the company form a third dimension of the COSO cube. This means that the activities in the components must be carried out for all processes of the company's relevant divisions.



6.4. COSO Enterprise Risk Management - Integrated Framework

In 2004 COSO published the Enterprise Risk Management – Integrated Framework (ERM) (COSO, 2004). ERM is not a replacement of the Internal Control - Integrated Framework. The ERM is included in the internal control framework and can be used both in order to establish proper internal control and to perfect the management process.

ERM can be seen as an extension of the internal control framework, the aim being to establish a powerful and detailed vision of the subject of risk management for businesses. The COSO also states that an internal control framework remains applicable as a generally accepted standard for meeting the requirements laid down in corporate governance laws and regulations, such as SOX. This idea is adhered to by inter alia the PCAOB, which following the appearance of ERM has continued to refer to the Internal Control - Integrated Framework of 1994.

Business that opt for ERM in setting up their ICF continue to report externally that they maintain the initial COSO framework. The reason for this is the references mentioned earlier, with the underlying idea that a business that reports more than it is asked to do so, is perhaps more vulnerable to claims.

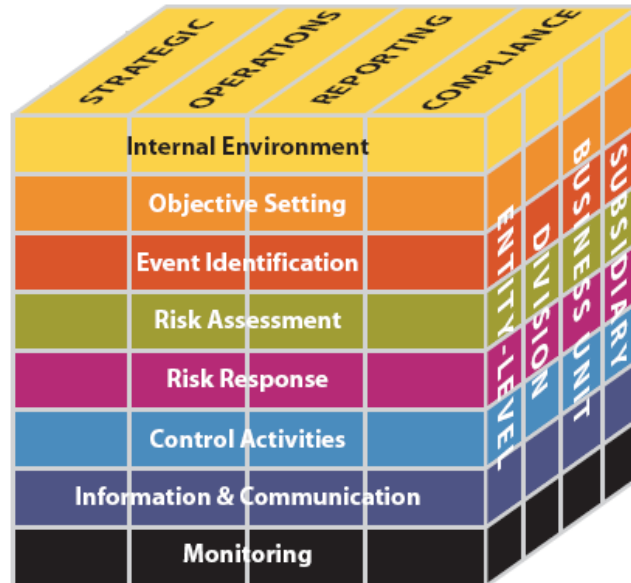
Compared with the internal control framework, the ERM has been extended by one category:

Strategic – high-level goals, aligned with and supporting the mission of the entity¹²

and three components aimed at risk management:

- objective setting;
- event identification en
- risk response.

The relationship between the internal control objectives and components is shown by the following cube.



.....
¹² Strategic objectives flow from an entity's mission or vision, and the operations, reporting, and compliance objectives should be aligned with them. Enterprise risk management is applied in strategy setting, as well as in working toward achievement of objectives in the other three categories. (COSO, 2004)

7. What does this mean for my work?

The client coordinator makes sure that the ZGO client profile is in order, that the processing team has a clear idea of the ZGO, knows what the core of the enterprise is and where its tax interests lie. In this regard he or she is aided by numerous sources, such as annual reports, annual accounts, the corporate website, press reports, publications, etc, which can provide him or her information about current issues. However, a ZGO client profile is shaped principally by information gleaned from the ZGO itself. The frequency of our contact with the ZGO is determined by factors including the size of the ZGO, the wishes of both parties, agreements made, and the kind of issues under discussion.

A client profile is to an important degree shaped by the study and assessment of its TCF. Without an assessment of the TCF, a client profile is not complete. The fact is that a TCF enables a business to be in control of its tax processes as well as to report to the Tax and Customs Administration tax-relevant matters ('risks') that are of any significance.

More than previously, the focus of the processing team will be on assessing the design, existence and operation of tax processes of a business and the extent to which they are under control. A TCF is always tailored to the business in question and a proper assessment of it is only possible if the processing team really knows the client. A full and up-to-date client profile is partly dependent on the assessment of the client's TCF. Client profile and TCF form an integral whole.

In carrying out horizontal monitoring, we assume that the ZGO and the Tax and Customs Administration trust one another. Mutual trust can be continually affirmed if both parties are transparent and fulfil agreements. A well functioning TCF enables a ZGO to recognise tax risks in due time. The basic tenet that a ZGO works continuously to improve its TCF is essential in order to maintain this relationship of trust. The Tax and Customs Administration shows its trustworthiness by being transparent itself, eg, by indicating why it asks particular questions or checks certain matters, as well as by explaining how it reaches its decisions. In covenants the Tax and Customs Administration commits itself to taking positions rapidly, bearing in mind existing commercial deadlines. Where required, processors must therefore establish links and make decisions quickly. Exceptions must be limited as much as possible, because a ZGO has to be able to trust promises made in the covenant. One should always be able to give reasons for departing from any existing agreement.

Working from the basis of trust requires a coordinated and integrated approach to all tax types and processes. The operation of a TCF should not be restricted to corporate tax. On the contrary, mass tax processes are more common in VAT and wage withholding tax and it is precisely these areas that for every imaginable reason should be brought under control. A ZGO creates the conditions for this by working on its TCF. The Tax and Customs Administration creates these conditions by working together in a processing team under the supervision of a client coordinator. The role of the client coordinator is set to change. Contacts with businesses will be less about technical problems relating to tax and much more about an open discussion with them about ways in which they can remain in control and

how they detect, select and cover tax risks. Both internally and externally, the client coordinator will have to prove him- or herself to be a true coordinator. In doing so he or she will give discussion parties feedback on behalf of the ZGO about the relationship in question and, where necessary, talk to specialists about their attitude.

In order to establish the right priorities and maintain a clear view of client processing, it is crucial that all processors record processing proposals and private work in the software application ATK. This makes it possible to make conscious selections and ensure progress in customer processing. ATK also enables the management to perform up-to-date monitoring of the various ZGOs and to divide the capacities of the Tax and Customs Administration evenly among the clients.

It does not mean, if a TCF exists and we work according to the principles of horizontal monitoring, that monitoring by the Tax and Customs Administration no longer applies. The Tax and Customs Administration continues to monitor. For a start we monitor the TCF itself, the operation of which will have to be assessed from time to time. It is also possible that a business has a TCF that is fine for the purposes of the business but that falls short of our standards. To start with, a TCF may focus on just one type of tax, eg, VAT. In that case we might then perform complementary audits. This we can also do if a TCF is not or not yet sufficiently in order. The aim of both the business and the Tax and Customs Administration must always be to improve its control. If monitoring activities show that a business has been insufficiently in control of its tax position, we then have to respond appropriately.

Both generalists (eg, the client coordinator) and specialists are required for horizontal monitoring. These include both tax specialists (eg, in VAT, wage tax and national insurance contributions, corporation tax) who can assess the tax risks and accountants and EDP auditors who are responsible for monitoring the administrative organisation of the business, including its TCF. Here we draw on work already done by others, such as internal and external accountants.

A TCF as well as the monitoring of it are always unique to the business in question. Thus there is no straightforward formula for a TCF format. Through intervision the various processing teams will, for example, be able to exchange experiences about TCFs in various businesses. This is necessary simply to ensure that the average standard of the TCFs remains comparable.

Just as a TCF is not restricted merely to the tax department of a ZGO but is part of the Business Control Framework and must be supported by the ZGO's entire organisation, so is horizontal monitoring not the province of the processing team alone. In the Tax and Customs Administration internal organisation pre-conditions must be created that make it possible to perform horizontal monitoring. Any bottlenecks in the structure of the organisation must be removed. Too much emphasis is still placed on individual tax types and processes. The desire to tackle each situation as an individual case will also have to be the fundamental approach for knowledge and coordination groups.

Thus it cannot only be the processors who will be affected by this paradigm shift. Changes will also be felt by those employees of the Tax and Customs

Administration who are less directly involved with clients but who make decisions that could have a direct impact on client processing.

8. Experiences with businesses to date

8.1. General

Within the scope of the pilot project six businesses were interviewed to discuss the production of a TCF. Simons's 'levers of control' model outlined earlier in this document was used as a tool in the interviews. Experience has taught us that this model contributes to providing a clear structure for the interview.

All businesses had started implementing a TCF. Differences between the businesses are considerable. It is noticeable that in some cases the TCF is limited to corporation tax and the processes within the business's tax department. At one business the set-up of an entire TCF was presented, encompassing all types of tax and all business and tax processes. The initiative to implement a TCF is usually taken by the tax department. The top tier management of a business actively backs up this initiative. The latter is important for successful implementation. Implementation at businesses falling under the SOx regimen is at a more advanced stage.

Different parties, both within and outside the business, are engaged in establishing, planning, controlling and monitoring tax strategy, eg, management, the tax department, the internal control department, the external auditor and the external tax consultant. Together they see to it that the TCF is embedded in the processes of the business.

Below please find some specific comments on what the businesses themselves have accomplished in this field and what the Tax and Customs Administration may do to gain a clear picture of a TCF.

8.2 The Netherlands Tax and Customs Administration

An adequate TCF is in line with the processes within the business. Should the Tax and Customs Administration wish to assess the TCF, it must first of all obtain an insight into the processes within the business.

The Tax and Customs Administration has adequate information of the relative business at its disposal. That information generates a general picture of the business from which the processes may be inferred. The following data is relevant in that regard: the business activities, size of the business, international activities, financial data and data relating to past processing of the business by the Tax and Customs Administration. An impression of the ICF may have been produced by way of a business survey or an audit.

The following data help improve our insight into the TCF: contacts with the business, contacts with the tax consultant or external auditor, corrections in the past and the manner in which these were made and/or resolved. This

information is available in the digital file (ATK) and/or from the processing team.

During the pilot project we met with the ZGO processing teams that were also involved in communication about the TCFs at various businesses participating in the survey.

One processing team is closely involved in the development of the TCF. The other processing teams monitor developments.

8.3 Set-up

Where businesses developed a TCF, the degree to which they actually tackle the processes turned out to vary. The following examples illustrate this:

- One business has developed a TCF as part of the BCF in the context of implementing SOx, using COSO as the standard. It has described and laid down the material processes in process schemes. The risks are stated in these processes. All risks are covered by key controls. The operation of these key controls is periodically tested in relation to the annual accounts audit and SOx. The TCF provides that the processes of the business's tax department are specified and that key controls are developed and tested for risks. Less attention is focused on the tax process in the other business processes.
- One business has the same processes but widens the scope of the TCF to also include operational processes. Noticeable is the attention focused on the tax process in innovation (product development). The tax department must assess new products (eg, to determine the VAT rate). The Risk Management & Internal Control department played an important part in setting up the TCF. Also noticeable at this business are that the various departments, of accounting, internal audit, internal control, tax and legal affairs, worked closely together to implement the TCF. The implementation is visibly backed up by the top tier management in the person of the CFO.
- One business has implemented the TCF based on the functional assessment in relation to transfer prices. The business has thereby availed itself of the structure of the European Masterfile for transfer prices documentation. The Masterfile provided the basis for the legal structure (country file) after which the set-up was shaped at the process level.

8.4. Other pilot project experiences

As indicated earlier, the interviews were in many cases based on Simons's 'levers of control' model. Below this will be followed by a general discussion

- based on the systems recognised within this model - of some experiences and results of the interviews.

8.5. Belief systems

A business management reaps benefits from controlling the business processes, not just in relation to the overall Business Control Framework, but also specifically in relation to the TCF.

In order to survey how the management designed its TCF one must understand its business and tax strategies. Such information may be inferred from information already available to the Tax and Customs Administration. Presuming that the customer data are up to date, this may provide information on the nature of the business, past conduct, extent of prior consultation, etc. Information may also be gathered from annual reports and other public statements. Completing the picture may be an interview about the management's strategic goals, focusing specific attention on compliance, not just with tax rules, but also with other laws and regulations. A business's corporate culture is also shaped to a large extent by the degree to which and the manner in which the management actually carries out such strategy within the organisation. In other words: the "Tone at the Top" is an important factor in a business's corporate culture.

Many of the interviews conducted during the pilot project were attended by a member of the Executive Board. Without exception, they indicated that compliance and integrity were important values in their corporate culture. These values are actively encouraged. An example of this is that at one business the top 200 managers jointly reviewed the documentary relating to Enron. All businesses focused attention on cultivating awareness among the business units that tax compliance is an important issue, usually by means of presentations accompanied by practical examples of where it had gone wrong.

8.6 Boundary systems

A business's tax department aims at performing the business's relevant tax obligations. This includes tax financial reporting, tax risk management, tax planning and tax cost management. In doing so it often liaises between the business and the Tax and Customs Administration.

Tax products/services, eg, the supply of tax-related information such as wage statements and bank-related information, are not provided by the tax department alone. Concluding a sales transaction (comprehensive information on proceeds) and issuing invoices (creation of 'vouchers') are tax products that come about in the operational process. The position and duties of the tax department determine the extent to which it has a role to play in that part of the TCF. The size of the department and the specific expertise of persons within that department are relevant factors in that regard.

An indication of the tax department's role within a TCF are the tax adjustments made. Where such adjustments are the result of inadequate expertise of the tax department in the field of operational activities this may be a signal that the tax department should be placed at a further distance from the operational departments. Where the adjustments are the result of a change in strategy, this may mean that the tax department is placed a further distance from management.

Based on the pilot project we have noted that the tax department generally takes the initiative to draw attention to the TCF within the organisation. It plays, to a varying extent, a role in formulating the tax aspects in internal guidelines and internal control.

The following experiences serve to illustrate the tax department's role:

- At one business the function of the Corporate Tax Department (CTD) is embedded as follows. The CTD falls under the immediate responsibility of the CFO. Departments falling under the CFO have weekly meetings at which they discuss developments. Based on what is discussed, they report to the Executive Board. The position of the CTD ensures that they are informed of all tax implications arising from product developments within the organisation. Every three months, the CTD reports to the audit committee. The CTD recognises a number of taxes in the Dutch situation. Partly because of SOx, the CTD focuses in particular on corporate income tax. Other taxes fall under the responsibility of different departments. The business realises that in relation to the TCF it should also be engaged in controlling other types of tax.

- At another business the tax department falls under the responsibility of the CFO. The business employs 5 persons in the Netherlands: a Group Tax manager, an International Tax manager, a person dealing with subsidies, a secretary, and a Tax accountant. The departments have the following duties:
 - strategic tax policy;
 - management of the Country Tax coordinators (20 people);
 - filing corporation tax, value-added tax and wage tax returns;
 - consolidating tax returns;
 - achieving compliance with tax legislation throughout the entire group, and
 - advising business units on tax matters.

- The tax department of another business has a list available of all types of tax that it deals with or might have to deal with. This ensures a complete picture of issues a TCF is required to articulate. For the time being, the focus of this TCF is on national taxes. In other words no local or municipal taxes. After the first interview a list was prepared of the key controls. In principle, they are the audit objectives at high level for each type of tax. They determine what the objectives of the control measures are. Thus it states, for example, that VAT-returns should be accurate, comprehensive and filed in good time. Regarding corporate income tax, the Executive Board announced that it would like to clarify its current tax position with the Tax and Customs Administration in good understanding. The company was very much behind with filing its final tax returns. The object of the AO/IC description is *inter alia* to list the

measures that would enhance the reliability and transparency of the tax return filing procedure.

8.7 Diagnostic control system

A business's internal control department is responsible for implementing its diagnostic control system. As regards the TCF this department must carry out the internal control measures to ensure that the tax-related business strategy is in fact embedded in the organisation. Regarding the state of the organisation one should make a distinction between set-up, existence and operation.

A survey of measures carried out for the internal control of a business's tax activities may clarify the role of the internal control department within the TCF. The duties of the internal control department, the intensiveness of tax audits, the content of questionnaires and the key controls are relevant in that regard.

Factors that the Tax and Customs Administration should consider regarding the TCF are the materiality adopted by the internal control department and the way in which it deals with the errors it uncovers. The way in which and the departments (including the tax department) to which the internal control department reports errors also has a bearing on uncovering of tax risks.

In the course of the pilot project we did not manage to assess the diagnostic control systems of all businesses. Interviews with those businesses did however show that tax controls were not always already adequately embedded in the internal control. The controls that are in place are of a repressive nature.

We list the following experiences of diagnostic control systems:

- At one business the internal control department is not yet geared to the tax aspects of operational activities. The ICs are operations-oriented and the observed shortcomings do not result in tax adjustments. The role of the external auditor complements that of internal control and is not specifically tax-oriented.
- At one business the idea is to incorporate the TCF in the BCF. The TCF has not yet been implemented although a rough outline is available. The way in which the TCF is described and set up seems to indicate an emphasis on repressive controls. Although they do seek assistance from the internal audit department for the tests, it seems that the tax department carries out the actual control duties.
- At one business the management itself is responsible for introducing and complying with policies in its own entity. Here SOx 404 plays an important part. There are tax controls within the tax department. They focus in particular on the duties/processes of the department itself. It is unclear how "tax" in the operational processes should be "in control".

8.8. Interactive control systems

What are the safeguards laid down in a TCF to ensure that amendments to laws and regulations *and* changes in the organisation are implemented and complied with?

One of the businesses has based its TCF on the TP Masterfile. Given the dynamic nature of the business, the TP Masterfile is updated annually.

These updates are carried over into the TCF. The development of the TCF has intensified contacts between the tax department and the operational departments. Quarterly meetings are held based on a fixed agenda with all those involved from Corporate, the business units and local (country) representatives. As a result, tax implications of changes in business models and goods or invoices flows are detected at an early stage. Acquisitions, in particular in countries in which business is new, and legislative amendments require a more detailed description and adjustment of the TCF. They seem well aware that the TCF is never "finished".

At one business in the financial sector it appeared that a great deal of attention was given to the tax implications of new products developed by the operational departments before being introduced into the market.

At another business, the tax department is involved in all relevant proposals within the organisation and reviews them in terms of tax issues. There is however no clear structure laying down how relevance to tax is assessed and when the tax department is or is not asked for advice. In order to keep abreast of the developments within the organisation, some staff members of the tax department are also physically present in certain other departments within the organisation. The tax department itself takes the view that it is insufficiently pro-active in the field of tax planning. The emphasis of activities is on the procedural side of corporation tax.

One of the businesses indicated that it has no written procedures for entering statements in the annual accounts and tax returns about incidental matters such as external tax consultations or agreements with the tax authorities.

At one business the nature of the business is such that the tax aspects of products must at all times be considered in the development of products. The organisation is adapted to this in the sense that within the tax department certain staff members are designated to monitor the development of the products.

Generally, the TCFs are still under construction and it would appear that interactive control mechanisms have not yet been implemented at all businesses. In the future the tax department should become more involved in the decision-making process of the organisation, by means of structured consultations with the various organisational units.

8.9. Recapitulation

The most important experiences gained from the TCF pilot project might be recapitulated as follows:

- Simons's 'levers of control' model is a very useful model for conducting interviews with businesses on how to develop or further develop horizontal monitoring.
- Establishing an up-to-date client profile is important in preparing the interviews on how to set up its TCF.
- In interviews explicit emphasis should be put on the 'tone at the top' in relation to compliance with relevant laws and regulations in general and tax laws and regulations in particular. Thus it is important that one or more members of the business's Executive Board attend the (initial) interviews.
- It is important to have a clear view of the role of the tax department within the organisation. Both its position and the work it has carried out are relevant in that regard.
- It is important to clearly define 'tax' within the context of the individual business.
- Regarding the internal control organisation and attention paid to tax processes, distinctions should be made between design, existence and operation. Experiences from the pilot project show that differences in the states of organisation are considerable right now. The experiences also tell us that discussions are an incentive for businesses to further improve their internal control organisation.
- TCF is about more than just corporation tax and preparing the returns. Aside from other types of tax, the quality of data provided by third parties and the quality of invoices to be issued and/or invoice data (actually a "credit note") are also relevant.

9. Components of internal control and of enterprise risk management according to COSO

9.1 Components of internal control (COSO, 1992)

- *Control Environment* — The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by the board of directors.
- *Risk Assessment* — Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. Because economic, industry, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change.
- *Control Activities* — Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.
- *Information and Communication* — Pertinent information must be identified, captured and communicated in a form and timeframe that enable people to carry out their responsibilities. Information systems produce reports, containing operational, financial and compliance-related information, that make it possible to run and control the business. They deal not only with internally generated data, but also information about external events, activities and conditions necessary to informed business decision-making and external reporting. Effective communication also must occur in a broader sense, flowing down, across and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as customers, suppliers, regulators and shareholders.
- *Monitoring* — Internal control systems need to be monitored—a process that assesses the quality of the system's performance over time. This is

accomplished through ongoing monitoring activities, separate evaluations or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top management and the board.

9.2. Components of enterprise risk management (COSO, 2004)

- *Internal Environment* – The internal environment encompasses the tone of an organization, and sets the basis for how risk is viewed and addressed by an entity's people, including risk management philosophy and risk appetite, integrity and ethical values, and the environment in which they operate.
- *Objective Setting* – Objectives must exist before management can identify potential events affecting their achievement. Enterprise risk management ensures that management has in place a process to set objectives and that the chosen objectives support and align with the entity's mission and are consistent with its risk appetite.
- *Event Identification* – Internal and external events affecting achievement of an entity's objectives must be identified, distinguishing between risks and opportunities. Opportunities are channelled back to management's strategy or objective-setting processes.
- *Risk Assessment* – Risks are analyzed, considering likelihood and impact, as a basis for determining how they should be managed. Risks are assessed on an inherent and a residual basis.
- *Risk Response* – Management selects risk responses – avoiding, accepting, reducing, or sharing risk – developing a set of actions to align risks with the entity's risk tolerances and risk appetite.
- *Control Activities* – Policies and procedures are established and implemented to help ensure the risk responses are effectively carried out.
- *Information and Communication* – Relevant information is identified, captured, and communicated in a form and timeframe that enable people to carry out their responsibilities. Effective communication also occurs in a broader sense, flowing down, across, and up the entity.
- *Monitoring* – The entirety of enterprise risk management is monitored and modifications made as necessary. Monitoring is accomplished through ongoing management activities, separate evaluations, or both.

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