TAX RISK MANAGEMENT IN THE POST-SARBANES-OXLEY ERA

Haroldene F. Wunder, College of Business Administration, California State University-Sacramento, Sacramento, CA 95819-6088, 916-278-7134, wunderh@csus.edu

ABSTRACT

The Enron, Worldcom, and other scandals in the United States and the Parmalat scandal in Italy ushered in a new era of financial reporting, corporate governance, and risk management reforms that extend beyond the United States. This manuscript reports the results of surveys sent to the chief financial officers of the Fortune 500 companies and the non-U.S. firms listed on the New York Stock Exchange, the purposes of which were to (i) ascertain if U. S. and non-U.S. multinational enterprises (MNEs) have adopted a *global* view of tax risk, and (ii) determine how MNEs rate the significance of various types of tax risk.

INTRODUCTION

Financial reporting, corporate governance, and risk management reforms extend well beyond the U. S. Sarbanes-Oxley Act of 2002 (SOX). For example, in early 2006, the European Union (EU) approved expansion of its 8th Council Directive on Company Law, which pertains to the approval of auditors in EU member states. Additionally, the Australian Stock Exchange has formalized its principles for recognizing and managing risk. The United Kingdom has promulgated similar guidance. The most significant result of these and similar laws is their raising exponentially the international financial community's awareness of the importance of risk management and internal controls. Risk management and other principles of corporate governance are being addressed around the world. According to the European Corporate Governance Institute (ECGI), a total of 60 countries and geographical areas, including the United States, have published new or updated existing codes of corporate governance to include and adequately address risk management principles. However, tax risk management has been accorded less focus than risk management generally. It has been common practice to subsume tax risk management under the general subject of risk management, rather than addressing tax risk management as a discrete aspect of risk management. Tax risk management and related internal controls have not necessarily been understood even by those in the tax function.

The impetus for the current research is the recent recognition by commercial organizations and revenue authorities that the tax function has its own unique profile, which necessitates a separate inquiry into tax risk management. Since formally classifying tax risk management as a separate element of corporate governance is a recent phenomenon, a dearth of empirical research exists as to how individual firms have responded and incorporated tax risk management into their governance policies and procedures and how they rate various aspects of tax risk management. The objective of this research is to fill that gap.

Specifically, this research elicits information about and compares U. S. and non-U.S. multinational enterprises (MNEs) to determine if a global view of tax risk management exists among MNEs or if country-specific views prevail. The inquiry elicits demographic and organizational information to provide a perspective from which to information and firms' assessments of seven types of tax risk and six specific tax issues.

RESEARCH DESIGN

The current research addresses *tax risk* from the perspective of *Tax Risk Management* (TRM), PricewaterhouseCoopers' 2004 discussion of the concept of tax risk and the elements of managing such risks, which itself employs the Committee of Sponsoring Organizations (COSO) Framework. Adopting the common practice of defining business risk in terms of uncertainties accompanying decisions, activities, and operations undertaken by an enterprise, TRM identifies the following seven areas of tax risk: (1) transactional risk, (2) operational risk, (3) compliance risk, (4) financial accounting risk, (5) portfolio risk, (6) management risk, and (7) reputational risk.

A survey instrument (to be distributed at the presentation) was sent to the chief financial officers (CFOs) of the U. S. Fortune 500 companies and the 453 non-U.S. firms that were listed on the New York Stock Exchange (NYSE) when the survey was distributed. CFOs (or their delegates) were asked to rate the risk associated with the seven TRM tax risk elements and six specific tax issues (transfer pricing, corporate income tax rates, value-added taxes, foreign tax credits, payroll taxes, and the effect of cultural norms on tax compliance in foreign countries) using five-point Likert scales.

The responses of the two MNE populations are compared using both nonparametric and parametric tests. The nonparametric Wilcoxon rank-sum test is applied because of the ordinal nature of Likert-scale responses. However, the number of total responses is more than sufficient to justify the parametric t-test, which increases the power of the tests.

RESULTS AND ANALYSIS

Usable responses were received from a total of 82 firms: 32 U. S. firms, representing 20 different industries, and 50 non-U.S. NYSE listed firms, representing 19 different countries and 24 different industries. With regard to the responses, a distinction must be made between the response *rate* and the *number* of responses received. The relatively low response *rate* was virtually a foregone conclusion since the surveys were sent to the CFO's of the largest MNEs in the world, for whom a survey from an academic researcher is not the highest daily priority. However, only CFOs (or their designees) possess the requisite knowledge to provide meaningful responses. Although the relatively low response *rate* limits the ability to generalize results to all MNEs, the *number* of complete, thoughtful responses is more than sufficient for the statistical tests that are applied to the data (discussed subsequently). The research proceeds on the premise that insights about tax risk management can only have been gleaned from CFOs (or their designees) and that the insights reported in this research are valuable in establishing at least preliminary conclusions about the MNE community's perceptions of tax risk management.

Seven Types of Tax Risk

The U. S. and the non-U.S. firms were surprisingly similar in their ratings of the seven types of tax risk and the six specific tax issues. With regard to the seven types of tax risk, both the nonparametric Wilcoxon test and the parametric t-test reveal that the two populations differ statistically only as to their ratings of operational risk. In other words, the results suggest that a global (i.e., non-country-specific) view exists among MNEs about six of the seven TRM tax risk elements: transactional risk, compliance risk, financial accounting risk, portfolio risk, management risk, and reputational risk.

It stands to reason that U.S. and foreign firms would have different perspectives about the tax risk associated with their operations. Virtually by definition, operational risk (tax or otherwise) is not only country- but firm-specific. Firms craft their operational structures to perpetuate their missions and satisfy stakeholders by leveraging relevant tax authorities' strictures. The more truly multinational a firm is, the more significant the impact of operating within multiple jurisdictions and under multiple tax laws.

Six Specific Tax Issues

When the nonparametric and parametric tests were applied to the firms' assessments of the six specific tax issues, results of the two tests are again virtually identical. The Wilcoxon rank-sum test results are such that the two populations differ statistically with regard to their assessments of (i) transfer pricing (null rejected at .001 level) and (ii) cultural norms' effect on tax compliance in foreign countries (null rejected at .05 level, but at the boundary of the .025 level). The t-test results are virtually identical to those of the Wilcoxon test.

With regard to transfer pricing, it is a significant potential exposure for all MNEs; however, the exposure differs for U. S. and foreign MNEs. U. S. transfer pricing documentation requirements, which are highly evolved and rigorous, preceded SOX. In contrast, other countries are scurrying *in response to SOX* (and to some extent U.S. Treasury Department Regulations) to develop transfer pricing documentation regimes. The comment of German Firm #2 describes the foreign-firm dilemma when it states that "[t]ax risk in transfer pricing is high, because there is often not enough expertise in tax authorities, i.e., to [sic] little understanding of relevant factors." In contrast, U. S. MNEs – steeped in experience pertaining to the Internal Revenue Code (IRC) Section 482 U. S. transfer pricing rules and associated 1996-enacted Regulation Section 1.6662-6 transfer pricing documentation requirements -- should assess less risk in transfer pricing.

Differences in results pertaining to the effect of cultural parameters on tax compliance were expected. Much of the preceding discussion in this research is relevant in explaining why the two populations differ statistically in their ratings of the risk associated with cultural norms' effect on tax compliance in foreign countries. Of the two populations, the foreign firms attributed greater risk to cultural norms' effect on tax compliance in foreign countries. On a scale of one to five, the foreign firms' and U.S. firms' mean responses were 2.40 and 1.91, respectively, causing rejection of the null of no difference at .05 significance level for the Wilcoxon rank-sum test and .025 level for the t-test. It is not surprising that U. S. firms would assess less impact from other countries' cultural norms because in matters of commerce the United States is accustomed to "affecting," not "being affected by," other countries.

CONCLUSIONS

Overall and with the few exceptions noted, the research results demonstrate that the responding U. S. and non-U.S. NYSE listed MNEs are characterized by an international view of tax risk and its management. The major contribution of the research is that it sets the stage for additional research as the concepts of tax risk management continue to evolve.

References, tabular presentations of Wilcoxon rank-sum test and t-test results, and survey instrument will be distributed with the full manuscript at the conference presentation.