



TAX RISK
AND RESPONSIBILITY

Identifying and Managing Risk in the
Post-Sarbanes-Oxley Business
Environment

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INTRODUCTION

The swirl of unsettling events preceding passage of the Sarbanes-Oxley Act of 2002 and the requirements of the legislation have put the corporate spotlight squarely on risk and responsibility. Business leaders, analysts, investors, regulators, academicians, and others are reassessing the roles and responsibilities of upper management, the board of directors, and external auditors. They are also scrutinizing financial reporting and related internal controls.

What are the risks threatening the accuracy and integrity of financial statement reporting? Have these risks been thoroughly assessed, and are they being managed effectively? Do internal controls over financial reporting need to be strengthened? These are some of the questions that business leaders in particular are asking themselves with great urgency in today's post-Sarbanes-Oxley business environment.

In answering these questions, many companies may want to take a closer look at an area that historically may not have received a great deal of attention from management and the board—the internal controls over the tax function.

As Grace Hinchman, the senior vice president of public affairs for Financial Executives International (FEI), a leading professional association of 15,000 CFOs, treasurers, and controllers, recently said: "In light of the circumstances surrounding Sarbanes-Oxley, risks related to financial management, financial reporting, and corporate governance have become a primary focus of senior financial executives. As a result, tax risks encountered by companies may now have been overshadowed."

RESPONDING TO A DRAMATICALLY DIFFERENT ENVIRONMENT

The vast majority of companies strive to faithfully fulfill their financial reporting responsibilities. In doing so, they scrupulously prepare their income tax returns and the financial statement reporting of their tax expense and provisions. However, in today's more skeptical and demanding political, regulatory, and investment environment, increased attention to internal controls associated with the tax function is essential.

The Sarbanes-Oxley Act—which Congress passed to help restore public confidence in U.S. capital markets—imposes new financial reporting obligations on corporate America. For instance, the legislation requires CEOs and CFOs to certify that their quarterly financial statements do not contain any untrue statement of a material fact, do not omit a statement of material fact, and are fairly presented. Under section 404 of the Act, management also must assess and assert to the effectiveness of internal control over financial reporting, and the company's external auditor must attest to those assertions.

In addition, section 204 of the Act requires that the independent auditor report certain information to the audit committee on a timely basis. That information includes communication of critical accounting policies and practices applied by management in the issuer's financial statements and may, depending on a company's profile, include information about accounting for taxes as a critical accounting policy. Audit committees are

also informed by the independent auditor about certain accounting estimates. Accounting estimates are an integral part of a company's financial statements prepared by management. A company's independent auditors should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates. In some instances, management's estimates relative to tax accounting matters are particularly sensitive accounting estimates, and the importance of the communication with the audit committee about the process used by management in formulating these estimates cannot be overstated.

In conjunction with the passage of the Sarbanes-Oxley Act, a sense of the Senate resolution was passed, indicating the desire that the CEO sign the corporate federal income tax return. Subsequent legislative proposals have sought to codify this resolution. Assuming this provision becomes law, the requirement will focus greater management scrutiny on tax issues and "up the ante" on internal control over the tax function. A rigorous evaluation of internal control over financial reporting should include a review of a company's internal control procedures related to its tax function. The reason is simple: Tax issues affect nearly every aspect of a company's business, and income, and non-income taxes represent one of the largest expenses in most income statements.

In taking a closer look at the tax function and its related controls, companies can better gauge the appropriateness of their tax provision and related financial statement disclosures. They can better determine whether a host of non-income taxes are being accurately estimated. In addition, they can gain greater assurance that relevant tax laws are being complied with across multiple jurisdictions—no easy matter considering the complexity of many tax laws and the frequency with which they change.

Such scrutiny can uncover opportunities to take full advantage of permissible tax exemptions and other favorable government-sanctioned provisions. In addition, it can help identify ways to improve the efficiency and effectiveness of the tax department.

This white paper examines how internal controls over the tax function can affect an entity's financial reporting and discusses common sources of risk. It also reviews actions companies can take to better identify and manage tax risk as they comply with section 404 requirements for internal control over financial reporting.

TAX RISK, MATERIALITY, AND EXTERNAL CAUSES

Risk is an integral and inescapable part of business; only by accepting certain risks can companies achieve growth and strong earnings. While no company would want to eliminate all risk, even if it could, all successful companies must identify and manage key risks—whether they threaten to prevent them from achieving their business objectives or undermine the integrity of their financial reporting. Before risks can be effectively managed, however, they must first be properly understood.

Tax is a critical area of risk for all companies. It is critical because the numerous taxes a company pays are embedded in nearly every aspect of its business—and in nearly every item on its financial statements. It is critical because underpayments or overpayments of taxes can have a material effect on those financial statements. And it is critical because a large underpayment, whatever its cause, can attract unfavorable press coverage and taint a company's reputation.

How do taxes make their way to the financial statements? And how do executives know they are paying all the required taxes—no more and no less? The answers to these questions go to the heart of internal controls over the tax function.

A simple example related to the purchase of raw materials illustrates how the internal controls over the tax function can lead to financial reporting risk. In buying raw materials, a company may incur sales and use tax, value-added tax (VAT), and federal excise tax. These taxes, in turn, will affect the cost of goods sold, inventory, and payables on the company's financial statements. The extent of this impact will depend on the cost of the raw materials and the amount of taxes paid or payable.

TAX IS EMBEDDED IN EVERY ASPECT OF BUSINESS						
	PROFIT AND LOSS ACCOUNT			BALANCE SHEET		
	Sales	X	<ul style="list-style-type: none"> ■ VAT, other transaction taxes ■ Cross-border issues ■ Location of activities 	Tangible assets	X	
<ul style="list-style-type: none"> ■ Customs duties ■ Transfer pricing issues 	Purchases	(X)		Intangible assets	X	<ul style="list-style-type: none"> ■ Location and use of intellectual property
	Manufacturing	(X)		Net current assets	<u>X</u>	<ul style="list-style-type: none"> ■ Cross-border issues
<ul style="list-style-type: none"> ■ Property taxes ■ Employee taxes ■ International executive taxation 	Overheads	(X)		Capital	<u>X</u>	
	Financing	(X)	<ul style="list-style-type: none"> ■ Treasury ■ Foreign exchange ■ Funding 	Reserves	X	<ul style="list-style-type: none"> ■ Profit repatriation flows
	Profit	X		Funding debt	<u>X</u>	
	Tax charge	<u>X</u>				
	Profit after tax	<u><u>X</u></u>				

TAXES AND FINANCIAL STATEMENT MATERIALITY

Income taxes have the most obvious impact on financial statements, which explains why the Financial Accounting Standards Board has set specific guidance on how to account for them. It also explains why companies are required to disclose detailed information about their income taxes in their financial statements. Despite the attention paid to income taxes, complying with complicated and changing income tax rules requires vigilance. Risk is always present to one degree or another.

Non-income tax activities ranging from sales and value-added taxes to accounting for intercompany, customs, and cross-border transactions can also exert a material impact on financial statements. It is not hard to find examples of this effect. Consider a case in which the U.S. government recently asserted that a large financial institution owed an unclaimed property liability of more than \$150 million.

A MATERIAL TRANSFER PRICING MISSTEP

A large U.S. multinational recently instituted a business-based strategy of using overseas losses to reduce taxable income in the United States. The strategy worked well when the U.S. market was hot but backfired when the domestic market fell apart and the company began suffering U.S. losses while recording taxable income overseas.

The company realized the strategy was going awry only after a new management team came in and instituted a far-reaching risk review program that included an in-depth assessment of transfer pricing issues. By that time, however, the strategy had led to a potential tax exposure in the hundreds of millions of dollars.

The potential exposure arose, in part, due to inadequate internal controls. Part of the problem also lay in understaffing at the company's foreign finance function and dispersed accountability for transfer pricing matters. If proper communication controls had been in place, an alert would have been sounded when information from overseas affiliates was inconsistent with expectations.

Complying with the disparate laws governing non-income taxes in multiple jurisdictions can be especially difficult, making risk harder to

identify and manage. It is made difficult, in part, because of the complex and frequently changing nature of these laws and related rules and regulations.

EXTERNAL DRIVERS OF TAX RISK

Tax risks faced by companies in the normal course of business may arise from a number of external political, regulatory, and marketplace forces. Evolving interpretations of complex technical tax and accounting issues can create tax risk as can the growing complexity and speed of business.

Legislative and regulatory activity coupled with the IRS's recent efforts to step up audit enforcement may pose heightened tax risk for companies that have implemented aggressive tax planning strategies over the past few years. Importantly, upper management, the board, and the audit committee may not fully appreciate the risks associated with these strategies due to their technical nature and complexity.

The vast majority of tax planning strategies employed by companies to lower their effective tax rates are supported by a sound business rationale and should stand up to IRS scrutiny. That does not mean that the IRS will not challenge them in light of new developments or alternate interpretations of the tax code since these strategies were implemented. A sound internal control process evaluates tax exposure items and the propriety of the accounting for such items. It is important that management's process includes addressing the impact of changing circumstances (including management's assumptions) on the accounting for tax exposure items.

Companies are confronting greater tax risk at the state level, too, as more U.S. states overhaul their tax codes to boost tax revenue and make up for staggering budget deficits. Fiscal 2003 state budget deficits were projected in early March to exceed \$30 billion, and fiscal 2004 deficits are forecast to hit \$80 billion.

Tax changes being implemented by some states include disallowing expenses paid to related parties, "de-linking" state income tax computations from the federal Internal Revenue Code, and expanding tax

INTERNAL CAUSES CONTRIBUTING TO TAX RISK

bases by imposing sales taxes on services. In some instances, these changes are being implemented retroactively. States are also increasing compliance scrutiny in many tax areas, including unclaimed property and business incentives and credits.

FINDERS KEEPERS? STATES TAKE A CLOSER LOOK AT UNCLAIMED PROPERTY

States require companies to remit unredeemed gift cards, uncashed checks, abandoned savings accounts, and other unclaimed property after a certain period of time. A large portion of this money often ends up in state coffers.

In the past, some states tended to overlook unclaimed property issues for hotels, retailers, and trucking and transportation companies, among others. Many of these companies responded to this tax scrutiny with tax monitoring and compliance. As their budget deficits have risen, however, states have begun paying more attention to potential unclaimed property liabilities, and so have many companies.

The reason is simple: Unclaimed property liabilities can add up to big money. For example, Delaware recently collected a \$57 million settlement for unclaimed property liabilities from a single taxpayer, which resolved most of its budget deficit for the year.

Tax reform is going on overseas as well, fueled by globalization along with domestic political and economic considerations. Last year alone saw significant tax reform in Germany, Italy, Mexico, and China. Furthermore, in July 2003 the 15 member countries of the European Union will begin imposing VAT on sales to European customers over the Internet, even if the businesses making the sales do not operate in one of the member countries.

Staying on top of complex and changing tax laws in multiple jurisdictions and communicating these changes appropriately throughout the organization are two of the stiffest tax challenges confronting companies both large and small. Things only get more complicated for multinationals expanding aggressively into new jurisdictions where they often encounter new and perhaps unfamiliar tax rules and regulations.

Tax risks can stem not only from various external sources but also from internal corporate events, activities, and operations. A merger or acquisition, for instance, or the launch of a new business venture in a new jurisdiction can spawn or exacerbate tax risk. Some tax risk exposures may be unidentified; others may be identified but not easily communicated outside of the tax department.

Inadequate communication often lies at the heart of tax risk. Communication breakdowns can and do occur, not only between headquarters and foreign subsidiaries but also between the tax department and other functions, and between the tax director and upper management, the board, and the audit committee. It is not uncommon, for instance, for news about expansions or contractions, product line changes, asset acquisitions and dispositions, and other business activities to reach tax departments late in the process. As a result, undetected mistakes in tax reporting or missed opportunities for tax planning can occur.

The marketing department might not think to alert the tax department to a new initiative, for instance, despite the fact that it could create tax liabilities in additional jurisdictions. And even when the tax department is informed, the added cost of doing business is not always factored into the decision-making process. Similarly, if a carmaker loses its qualification for a tax exemption due to a change in the law, the disqualification might not always be communicated across business unit lines, possibly resulting in underreported sales and use tax.

CROSSED COMMUNICATION WIRES

Different departments sometimes cross their "tax wires." Such was the case when the corporate real estate department at a large manufacturer mistakenly booked certain real property assets as personal property and reported them as such to the local tax jurisdiction. On receiving this information, the tax authority proceeded to collect taxes on those assets as personal property, even though its real estate division was already subjecting the same assets to real property taxes. Fortunately for the manufacturer, a tax review revealed the overpayment, which totaled more than \$2 million.

DEGREES OF AUTONOMY

Past KPMG studies have found that C-level executives consistently rank tax-related issues as a low priority. Why is this the case? The reasons vary from company to company. Upper management and boards at many companies tend to shy away from what they perceive as complex and arcane tax matters. Often, they simply don't appreciate the full extent to which tax issues can affect financial statement reporting. Time also plays a role. There are only so many hours in a day, and busy executives and board members must set priorities in order to address the countless corporate matters demanding their attention.

TAX RISK AND CHANGES AT THE TOP OF THE TAX DEPARTMENT

A large industrial company saw its tax risk profile change overnight with the appointment of a new tax director who tended to pursue more favorable business-based tax planning strategies than his conservative predecessor.

The new tax director's tax planning stance was not troubling in itself. Indeed, it may be the best course to take for new business strategies or activities. What did cause concern, however, was the fact that upper management and the board remained unaware that the company's tax risk profile had changed.

Upper management and the board were unaware of the change in part because the company had never instituted procedures to help keep tax planning in tune with the overall corporate risk approach. The lack of awareness also stemmed from inadequate lines of communication between the tax director and upper management and the board.

Of course, many organizations have established strong lines of communication between their tax directors and upper management, and others are in the process of forging them. A Fortune 200 financial services company, for instance, recently created a tax risk management

committee to review tax planning strategies and proposed transactions. Comprising tax professionals and their non-tax colleagues from such areas as legal, operations, and finance, the committee provides a forum for discussing the appropriate degree of tax planning risk to take on for individual business transactions. The financial services company also found that the committee promotes a cross-functional approach to identifying and managing possible tax risk.

Forming this type of committee to determine the right level of tax risk may not work for all companies. There is no one-size-fits-all solution. However, many companies could benefit from finding appropriate ways to open better lines of communication between tax directors and their upper management, boards, and audit committees.

Tax directors are taking action on their own in some instances. They are revisiting whether their accounting for taxes is required to be disclosed as a critical accounting policy to audit committees. In light of the Sarbanes-Oxley Act, more are sitting down with CFOs or audit committees to discuss the appropriateness of tax exposure reserves. They are reviewing compliance processes implemented to help ensure that tax returns are filed accurately and on time. And they are presenting the results of legal-entity reviews, which are conducted to help ensure that entities are properly accounted for from a tax perspective.

DECENTRALIZATION AND DISPERSED ACCOUNTABILITY

In the absence of rigorous internal controls and procedures, decentralized tax reporting structures may often lead to increased tax risk. Decentralized reporting structures are especially common for such income tax areas as compensation and benefits and such non-income tax areas as sales and use tax, unclaimed property, customs, and excise tax. It is not unusual, for instance, to decentralize sales and use tax compliance, even though these taxes can quickly add up to a significant tax liability.

Decentralization can be especially vexing for large multinationals. Communicating between headquarters and foreign affiliates across different time zones and in different cultural environments is intrinsically difficult. The difficulties only multiply when complicated tax issues and often-changing tax laws are the topic of discussion.

Tax risks sometimes emerge when companies do not assign sufficiently seasoned people to oversee various tax matters. This often happens due to a lack of adequate resources. Many companies, for instance, do not assign an individual to oversee or monitor the incentive and credit agreements negotiated with states before locating or expanding facilities there. As a result, they may not know whether they are in compliance with these contracts. That's what happened at a large airline compelled to pay \$40 million in 2002 for failing to live up to such an agreement.

OUTSOURCING, M&A ACTIVITY, AND OTHER SOURCES OF TAX RISK

Tax risks can also spring from outsourcing certain compliance responsibilities, a common practice in such areas as payroll tax, sales and use tax, and tax return preparation. Successful outsourcing—often an effective and cost-efficient approach to managing a tax function—depends on frequent communication between the company and its outsourcing

provider. When tax departments are short on resources, however, no one at the company may be diligently communicating with the outsourcing provider and responding to requests for information or guidance. A possible result is noncompliance and increased tax exposure.

Other activities that may bring heightened tax risk as an unintended consequence include implementing new enterprise resource planning (ERP) systems, entering into a merger or making an acquisition, restructuring the head office or administrative functions, and installing new IT systems. In installing a new ERP system, for instance, companies must take care to ensure that income, deduction, and credit data required by the IRS are not lost. The inability to produce such data may lead to hefty penalties or expensive system restoration costs.

TAX RISK AND M&A ACTIVITY

Several years ago, a large financial institution inherited a complex benefits program as part of an acquisition. In assuming the plan's administration, as required by the tax rules, the company inadvertently miscalculated benefits for more than 1,000 people in the plan.

Benefits were calculated on more than twice the participants' actual salary in some cases. In others they were calculated on less than half of the actual salary. By the time the financial institution discovered the errors, recalculated the correct benefits, and settled matters with the IRS, related liabilities were in the millions of dollars.

The miscalculations could have been avoided if proper care had been taken in assuming the plan's administration, and they would have been detected if proper and effective controls had been instituted. However, M&A activity often brings such an onslaught of issues that some of the details, no matter how important, may be overlooked.

INTERNAL CONTROLS AND THE CROSSCURRENTS OF SARBANES-OXLEY SECTION 404

Just as the Sarbanes-Oxley Act and the unsettling developments that preceded its passage have brought intense scrutiny to corporate governance issues, section 404 of the Act is drawing increasing attention to internal control over financial reporting. Although the SEC has deferred the effective dates associated with internal control reporting, companies large and small have begun to reevaluate their existing internal controls and procedures over financial reporting.

It would be a mistake to think that the scope of section 404 is limited solely to the finance function. As the March 6, 2003, edition of CFO.com stated: "Indeed if you thought the provisions of Sarbanes-Oxley only concerned corporate finance, independent auditing, and equity research, you've missed the fine print. SarBox also covers such disparate corporate functions as information technology, human resources, compensation, and environmental compliance. Why? Because these areas—and a host of others—affect company financials."

Tax is one of those areas, as evidenced by the impact that both income and non-income taxes can have on financial reporting. To support its assertion on the effectiveness of internal control over financial reporting, management will need to identify and evaluate the design and operating effectiveness of all *significant* controls over financial reporting—including the controls over tax activities that may have a material impact on financial statements. Some companies may also wish to broaden their scrutiny of controls beyond just those deemed significant, seizing the opportunity to improve operations and implement best practices across various functions.

SECTION 404 PUTS THE SPOTLIGHT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Section 404 of the Sarbanes-Oxley Act emphasizes the importance of sound internal controls for ensuring the accuracy and integrity of financial reporting. It stipulates that:

- Management must establish and maintain an adequate internal control structure and procedures for financial reporting.
- Management must assess the effectiveness of the internal control structure and procedures for financial reporting and make assertions about these matters
- A company's external auditor must attest to management's assertions about its internal control assessment.

THE STATE OF TAX DEPARTMENT CONTROLS

Internal controls related to the tax compliance and reporting function traditionally have not received as much attention from upper management as other areas of operations. Some CFOs and CEOs tend to focus on tax expense per se, not on how the expense, reserves, and deferred accounts are developed.

Corporate tax functions that routinely deal with complex tax matters may have documented processes and instituted internal controls, especially for income tax-related activities. However, not all tax functions have formalized, well-documented processes and related internal controls for managing tax-related activities.

Inadequate documentation of controls designed to prevent or detect misstatement or fraud in significant financial statement account balances, classes of transactions, and disclosures has an effect on how a company's independent auditor evaluates management's assertions on the effectiveness of internal control over financial reporting. Without

such documentation, in fact, the auditor would have to conclude that management lacks sufficient evidence to support its assertions about internal control over financial reporting. To avoid this, management should include tax-related processes, procedures, and related controls in its evaluation of the effectiveness of internal control over financial reporting.

THE CHALLENGES AHEAD

In complying with section 404 requirements, management may need to ensure that the tax risks threatening achievement of tax-related financial reporting objectives are identified and that adequate controls are in place to manage these risks. For instance, management may need to assess the design of periodic tax department meetings to identify tax risk arising from aggressive tax positions or other significant tax activities. In evaluating the operating effectiveness of these meetings, furthermore, management may need to look at the frequency of the meetings, who attends them, what is discussed, and what type of follow-up action is taken.

Proactive tax departments are beginning to assess the section 404 challenges facing them. What lies ahead for many may be considerable work and wide-ranging action to improve tax control processes and procedures. Tax department professionals will need to play a central role in these efforts, given the complex and rapidly changing nature of tax matters.

Some tax directors may not be aware of the extensive time and resources required to evaluate the effectiveness of internal controls using suitable criteria, such as those spelled out by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission in its report, *Internal Control—Integrated Framework*. Furthermore, tax directors and the professionals reporting to them may lack the requisite knowledge of COSO criteria to properly plan the evaluation process,

document the design of significant controls for all significant locations and business units, evaluate the design and operating effectiveness of these internal controls, and identify and correct deficiencies.

THE COSO FRAMEWORK FOR INTERNAL CONTROL

The most widely accepted internal control framework in the United States was developed by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. COSO defines internal control as a process implemented by a company's board of directors, management, and other personnel and designed to provide reasonable assurance that it will achieve specific objectives—including those related to the effectiveness and efficiency of operations, compliance with applicable laws and regulations, and the reliability of financial reporting.

The COSO framework lays out evaluation criteria for the following five internal control components:

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring

The *control environment* in a tax department could include a description of the skills required for tax department positions and documentation of policies and procedures as well as other factors. In the area of *risk assessment*, the tax department should identify tax risks arising not only from internal sources and events but also from external sources, including taxing jurisdictions, other regulatory agencies, courts, and third-party providers.

In the area of *control activities*, the tax department may need to identify and document the comprehensive controls needed to achieve corporate financial reporting objectives and mitigate risks, including:

- Policies and procedures for tax operations, including approvals and authorizations for tax planning initiatives and tax filing positions
- Segregation of duties within the tax department, or in conjunction with accounting and treasury, where appropriate
- Reconciliation of taxable income and tax accounts to general ledger balances
- Data- and documentation-retention requirements

The *information and communication* component of COSO should entail an evaluation of whether the data provided by corporate information systems is sufficiently detailed for tax purposes. And the *monitoring process* from a tax perspective could include internal control evaluations performed by management or internal audit groups as well as comparison to key performance indicators and budgets or forecasts.

More effective internal controls can help prevent or mitigate tax risks. Suppose, for instance, that a company records cross-border service transactions but fails to document them appropriately. In performing an internal control task, the company then discovers that contracts for a number of these intercompany transactions do not exist and the transactions have been entered inconsistently. If the mistake is not discovered and corrected on a timely basis, it can result in adjustments to intercompany accounts, restatement of the tax liability, and potentially significant penalties for incomplete documentation. With the proper internal controls in place, however, the company can identify and rectify the mistake at an early date and properly reflect these transactions in its financial statements.

As more companies scrutinize their internal controls for significant tax activities, some may conclude that these controls are sufficient to meet their Sarbanes-Oxley obligations. But others may conclude that they need to more rigorously review controls for those tax activities that can exert a material impact on financial statement reporting. In strengthening those controls, companies can not only gain greater assurance about the integrity of their financial reporting but also uncover ways to improve tax department operations.

AN ABRIDGED INTERNAL CONTROLS REVIEW

In light of the provisions of Sarbanes-Oxley section 404, a company should assess internal controls implemented to ensure its tax returns are filed accurately and on time. Areas that may warrant close examination include:

- Financial statement accruals for tax exposures
- Valuation of tax and deferred tax accounts
- Tax disclosures in financial statements
- Consistency of tax returns filed across multiple jurisdictions
- The need for tax-related controls over accounting and reporting of sales, customs, excise, value-added, and other non-income taxes
- Tax planning documentation
- Data- and document-retention policies

IDENTIFYING AND MANAGING TAX RISK: A MAP FOR THE FUTURE

As companies intensify their scrutiny of financial reporting risks and controls in the post-Sarbanes-Oxley business environment, many are taking a harder look at their tax compliance and planning practices and processes. In the process, they are exploring ways to better identify and manage tax risks that threaten the accuracy and integrity of their financial statements.

Forging better lines of communication between the tax department and other functions will be essential to achieving these goals at many organizations. Upper management, boards, and audit committees can take an important step in this direction by making more room at the table for tax directors.

TAX EXPOSURE PAST, PRESENT, AND FUTURE

The task of diligently identifying and managing specific tax risks starts with a careful examination of tax matters past and present. Companies need to (1) make sure their tax position in major tax jurisdictions can stand up to local audit scrutiny and (2) identify significant tax exposure.

Companies need to look ahead, as well. They should map out the various taxes that may impact financial statements and document the processes followed in preparing tax returns and provisions. Doing so can help prevent or mitigate future tax exposures and ensure that the tax function can survive the unexpected departure of a key employee.

Most companies could also benefit from training their tax personnel in internal control concepts and the COSO framework. Such training should be designed to help individuals to effectively plan, document, and evaluate tax-related internal controls, as well as identify and correct any deficiencies. In addition, companies must adequately staff their tax functions so that their tax professionals can do the job demanded of them.

POSSIBLE BENEFITS OF A RIGOROUS TAX RISK REVIEW

- Identify potential tax exposures and quantify their impact
- Develop possible strategies to reduce or eliminate taxes and penalties associated with potential tax exposures
- Satisfactorily review the sufficiency of accruals for potential tax exposures at both the U.S. consolidated and local statutory account levels
- Identify potential refund opportunities
- Identify ways to improve tax process efficiencies
- Develop and implement more effective financial reporting controls and practices, along with improved tax compliance procedures
- Better understand foreign tax filings and positions to improve foreign tax planning and enhance cash flow
- Fully understand record-retention requirements in individual countries and reveal any existing deficiencies in corporate record-retention policies

Taking steps to better identify and manage tax risks can bring tangible rewards. One of the biggest rewards in today's business environment would be helping to ensure the appropriateness of the tax provision and related financial reporting disclosures. Only after a company takes such steps can upper management, the board, and tax directors rest easier about the reliability of the tax information used to prepare company financial statements.

CONCLUSION

The corporate landscape has been radically transformed by the startling series of events that have shaken the very foundation of U.S. capital markets since the fall of 2001. Perhaps never before have publicly held companies seen so many tumultuous changes come so quickly in such fundamental areas as corporate governance and financial reporting.

These changes—many of which are mandated by the Sarbanes-Oxley Act of 2002—require upper management and board members to adopt a broader perspective on both risk and responsibility. They require greater vigilance against those eventualities or activities that can undermine the accuracy and integrity of a company's financial statements and financial reporting process. And they impose stiff new penalties for those who do not live up to their new responsibilities.

As upper management, boards, and audit committees respond to the demands of today's fast-changing marketplace and regulatory environment, as they move to ensure the accuracy and integrity of their financial statements, they may want to pay more attention to tax risks that may have a material impact on financial statements.

By more diligently identifying and managing these risks, companies can better meet their obligations under the Sarbanes-Oxley Act. In addition, they can help improve the efficiency and effectiveness of their tax department operations as they seek ways to gain or retain a competitive edge in today's intensely competitive marketplace.

