Journal of International Accounting, Auditing and Taxation 18 (2009) 14–28

Contents lists available at ScienceDirect

Journal of International Accounting, Auditing and Taxation

Tax risk management and the multinational enterprise

Haroldene F. Wunder *

College of Business Administration, California State University, 6000 "J" Street, Sacramento, CA 95819-6088, United States

ARTICLE INFO

Keywords:
Risk management
Tax risk management
Multinational enterprise

ABSTRACT

The financial scandals in the United States and other countries ushered in financial reporting and corporate governance reforms that extend beyond the U.S. Sarbanes-Oxley Act of 2002 (SOX). These initiatives have increased the international financial community's awareness of the importance of risk management and internal controls. Tax risk management and related internal controls have been accorded less focus than risk management generally. The purpose of this research is to describe the current state of tax risk management of multinational enterprises (MNEs) by reporting survey responses from chief financial officers (CFOs) of U.S. and non-U.S. MNEs. The research shows that significant progress has been made by large MNEs in developing and implementing both general and tax risk management policies. The results provide guidance in identifying the loci and impact of organizational tax risk and indicate that respondents do not perceive alarming degrees of tax risk in their organizations. The study reveals a remarkable degree of similarity in U.S. and foreign firm responses and demonstrates, unexpectedly, that existing reporting structures enable CFOs to shift a significant degree of tax risk management to heads of tax.

1. Introduction

As a result of financial scandals such as the Enron and Worldcom scandals in the United States, the Parmalat implosion in Italy, the Maxwell pension debacle in the United Kingdom, and the HIH Insurance failure in Australia, a new era of financial reporting and corporate governance reforms was ushered in that extend 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. Member states have 2 years from its formal adoption (summer 2006) to incorporate its requirements into their national laws (Wyman, 2006).

The most significant result of these laws is the increased awareness by the international financial community 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 66 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. Additionally, in July 2005, the International Corporate Governance Network (ICGN) updated its 1999 *ICGN Statement on Global Corporate Governance Principles*, to charge corporate boards with ensuring that appropriate systems of control are in place, including systems for risk management.

Tax risk management and related internal controls have 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

* Tel.: +1 916 278 7134.
E-mail address: wunderh@csus.edu.

1061-9518/$ – see front matter © 2009 Elsevier Inc. All rights reserved.
doi:10.1016/j.intaccaudtax.2008.12.003

have been described historically as "a bit of black art, not necessarily understood even by those in the tax function. . .." (PricewaterhouseCoopers, 2004, p. 2).

Furthermore, material weakness disclosures by management frequently identify internal control problems in complex accounts, such as income tax expense (Ge & McVay, 2005). Quimby and Pearce (2006, p. 26) conclude that "[a]rguably, no one has felt the sting of SOX 404 more acutely than the tax departments." Elgood (2006) reports that more than 20% of material weaknesses reported under section 404 of SOX pertained to how tax is controlled. Quimby and Pearce (2006, p. 26) concur and confirm that for the second year in a row, tax departments held the "dubious distinction of being one of the most common areas of internal control failure (material weakness) cited in the adverse opinions filed in 2005 (Year 2)."

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 rate various types of tax risk and have incorporated tax risk management into their governance policies and procedures. The contribution of this research is that it fills the information and decision making guidance gap by describing the "state of tax risk management" of some of the world's largest multinational enterprises (MNEs). The research is relevant to accounting, auditing, and taxation academicians and practitioners because tax risk management is at the confluence of all three disciplines.

Specifically, this research elicits information about and compares U.S. and non-U.S. MNEs to determine the current state of tax risk management and if a global view of, and strategies pertaining to, tax risk management exists among MNEs. The inquiry addresses the following aspects of tax risk management for U.S. and non-U.S. firms: (i) the structure of and the chain of reporting pertaining to the tax function, (ii) the existence and nature of a documented general and tax risk management policies, and (iii) firms' ratings of seven types of tax risk and six specific tax issues. For example, the research describes the significance of transfer pricing rules and their disproportionate effect on the tax risk experienced by non-U.S. multinationals firms. The study also provides demographic and organizational information as a perspective from which to draw conclusions about the aspects of tax risk management identified above.

The study provides insights for identifying the loci and significance of organizational tax risk and developing and implementing tax risk management policies to adequately control risk. It is also relevant to corporate boards and senior management. Neubig and Sangha (2004) conclude that boards' and senior managements' lack of understanding of the complicated and technical nature of tax may expose companies to unexpected outcomes (i.e., risk). Finally, the current research updates the results of a 2005 KPMG study that looked at enterprises' adoption of formal tax risk management policies and demonstrates that significant progress has been made since 2005.

In effect, the study constitutes a benchmark against which decision makers can assess organizational tax risk efforts. The information about U.S. and foreign MNEs' development and implementation of documented risk management policies constitutes a set of best practices. The significance of these risk management best practices is confirmed by Ernst & Young's (2007) series of 2006 risk management surveys, which demonstrate that 66% of surveyed companies plan to increase their investment in risk management in order to manage risk in a more coordinated and integrated manner.

2. Background

The current relevance and importance of tax risk management is demonstrated by the number of current initiatives occurring worldwide. Revenue authorities and commercial organizations around the world have begun to address tax risk as a discrete element of risk management. For example, in June 2003, the Australian Taxation Office (ATO) issued *Large Business and Tax Compliance* to launch a campaign to elevate tax governance to the boardroom. The ATO has since augmented its original initiative by examining companies' tax risk management procedures as part of its audit and risk review process and has published the 2006 version of *Large Business and Tax Compliance*, which systematically addresses tax risk concepts (Australian Taxation Office, 2006).

In 2005, Ireland Revenue Authority issued *The Cooperative Approach to Tax Compliance*, requiring that businesses prepare and implement annual tax risk management plans, focusing on identified risk areas. Revenue's risk review will determine the precise combination of self-audits and Revenue audits (Fennell, 2005).

From a commercial perspective, two 2005 Big-Four firm surveys produced similar results. A Deloitte survey of tax directors of 350 U.K. companies revealed that corporate attitudes toward tax risk in the U.K. have changed significantly and that the proportion of tax directors that describe their approach to tax as conservative has increased from 17% to 35% from 2003 to 2005 (Crest, 2005b). Similarly, 44% of respondents to an Ernst & Young survey of 354 tax directors showed that companies have become more risk averse in the 2 preceding years, with 75% of respondents also stating that risk management is a criterion upon which their performance is measured (O'Sullivan, 2005). More recently, in connection with its 2006 global tax risk survey, Ernst & Young (2006, p. 4) concludes that establishing a written, comprehensive and sustainable tax risk management framework is "a best practice."

In a similar vein, *International Tax Review* received 162 responses from tax executives in connection with its 2005 survey of international tax services in Asia. An issue that first surfaced in that survey is tax executives' desire for their tax advisers to understand better their appetite for tax risk. The responding tax executives want their tax advisers to understand and appreciate the effect of tax risk on how clients structure operations and the extent to which they will expose themselves to