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SOX and APAs: A Look at Their Compatibility

BY MITCH MCGHEE

The Sarbanes-Oxley Act was enacted by Congress to prevent future accounting misconduct as exemplified by Enron and WorldCom. SOX addressed several areas that Congress felt needed strengthening in order to enhance the compilation and presentation of financial statements and information to the public. This column examines how Advance Pricing Agreements (APAs) might provide support for meeting the obligations placed on firms by two of those items—SOX Sections 302, Corporate responsibility for financial reports, and 404, Management assessment of internal controls. The scope of this application applies only to domestic or multinational firms that have transfer pricing concerns between related parties. While this scope may be narrow, it can have a significant impact on those firms that face this issue and must comply with the Act.

Applicable SOX Sections

The selection of these two sections is in no way meant to indicate they are of greater or lesser importance than any other section of the Act. They were chosen because of their requirements for having an internal control system and the need to certify the effectiveness of the system. Given the potential for litigation and penalties for corporations and accounting firms if they are accused of not meeting these obligations, any approach that provides substantiation of internal control procedures could provide protection against such claims.

Since most readers are familiar with the actual language of SOX, only a brief discussion of the two sections will be given. Basically, Section 302 requires the principal executive and financial officers to review the financial reports and attest that they present fairly all material information. Section 404 relates to the assessment of internal controls and how it relates to the financial reporting process. This is where the APAs can play the greatest role in supporting management, the positions they take, and the accurate reporting of the financial information with the lowest chance of a material misstatement.

Because of these standards, firms need to consider using whatever is beneficial in meeting the new SOX standards for reporting. It is my view that APAs between the Internal Revenue Service (IRS) and companies concerned with transfer pricing issues provide those companies with an outside, authoritative source of support for the procedures adopted to present fairly the financial operations of the firm.

Advance Pricing Agreements

APAs are granted under authority of IRC §482, Allocation of income and deductions among taxpayers. The current process that controls the program functions is presented in Revenue Procedure 2006-9, which was published on January 9, 2006. Section 2.04 of this revenue procedure defines an APA as "…an agreement between a taxpayer and the Service in which the parties set forth, in advance of controlled transactions, the best transfer pricing method (TPM) within the meaning of Section 482 of the Code and the regulations. The agreement specifies the controlled transactions or transfers (covered transaction), TPM, APA term, operational and compliance provisions, appropriate adjustments, critical assumptions regarding future events, required APA records, and annual reporting responsibilities." Section 2.01 states, "The APA Program provides a voluntary process whereby the Internal Revenue Service (Service) and taxpayers may resolve transfer pricing issues under Section 482 of the Internal Revenue Code (Code), the Income Tax Regulations (the regulations) thereunder, and relevant income tax treaties to which the United States is a party in a principled and cooperative manner on a prospective basis. The APA process increases the efficiency of tax administration by encouraging taxpayers to come forward and present to the Service all the facts relevant to a proper transfer pricing analysis and to work towards a mutual agreement in a spirit of openness and cooperation. The prospective nature of APAs lessens the burden of compliance by giving taxpayers greater certainty regarding their transfer pricing methods, and promotes the principled resolution of these issues by allowing for their discussion and resolution in advance before the consequences of such resolution are fully known to taxpayers and the Service."

Sections 2.01 and 2.04 encompass the heart and motivation for acquiring an APA (whether it be a unilateral, bilateral, or multilateral agreement): the reduction of uncertainty and the avoidance of adverse adjustments to taxable income. The increase in APA applications shows just how valuable the uncertainty reduction and adverse adjustment avoidance are becoming. According to APA Program Statistics, 401 applications were filed from 1991 through 1999. Over the next six years, an additional 527 applications were filed. From 1991 through 2005, 610 APAs were executed.

The Compatibility of SOX and APAs

In order to have internal controls, a company must have established procedures for the operations of the business. While this may sound simple and clearly doable, it is not unusual to find that management has yet to institute specific procedures for its employees to follow in all the different situations that they might encounter. The greater the flexibility and option that employees have in dealing with specific situations that arise, the greater the chances that management won't be aware of improper transactions. Two major thrusts of SOX are implementing internal controls and mandating senior management to verify the effectiveness of those controls, as stated in Section 302(a)(4). Adherence to established APA procedures that must be followed at all times for a particular situation provides the environment for the development of internal controls that meet SOX requirements. For companies that fall under the scope of IRC §482, selecting a transfer pricing method that allows the company to consistently calculate the proper allocation of revenues, expenses, credits, or allowances between or among various commonly controlled operations without concern of a material misstatement will help meet the requirements of SOX Sections 302(a)(2) and (3).

Procedures required for receiving the APA include a vetting process by which the justification for the selected TPM has been agreed to by both the taxpayer and the IRS. The mutually agreed upon standard provides authoritative support for the method selected to reflect a proper allocation of revenues and expenses. It also provides the specific steps or procedures to be used in obtaining proper and consistent results, which makes the development of effective, SOX-compliant internal controls more attainable and acceptable.

Multiple Benefits

The nexus of SOX and APAs provides two mutually beneficial results. The APA provides for an annual reporting of the TPM. The internal controls associated with the TPM will help to meet the requirements of SOX, which, in turn, provide the basis for meeting the reporting requirements of the APA. This relationship should make the APA filing process more economical and provide a greater benefit to the company. In fact, in light of the accelerated movement toward the use of APAs, the argument could be made that not using APAs could place a company at a disadvantage in defending itself if there are material misstatements that could have been prevented had an APA been in place.

The concern about material misstatements and the impact they can have on the officers responsible for issuing the financial reports will motivate a firm toward adopting APAs, whose internal financial procedures support and assist in adopting SOX procedures that reduce the chances a material misstatement will occur. ■

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