

# The Impact of the Implementation of Sarbanes Oxley Act 2002 towards Transfer Pricing Policy on the US Companies

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## **Abstract**

*Along with the increasing power of global corporations, the tendency of the emergence of numerous competitions among corporations also enhanced. The number of privatized state-owned enterprises grows. At the local and national level, the records show the success of the government in releasing the state-owned company's shares to the public to the private companies. At the international level, there are various negotiations conducted in order to enhance the agenda of trade liberalization which facilitated the rise of the corporations. Several important advancements aimed to strengthen the corporations must be accompanied by particular set of rules that allow them to compete and operate fairly. The compliance with the Sarbanes Oxley Act (SOA) can be tricky, especially for corporations that have used a relatively long approach to monitor transfer pricing. The process requires a systematic and rigorous implementation in order to be able to identify material transactions and to ensure that taxpayers do not only have the correct transfer pricing policy, but also to ensure this policy is followed. In the end, the policy chosen should be able to identify and lead to a better understanding of the risks and a greater ability to develop appropriate documentations, taking into account the specific risks and the parties involved. The emergence of the SOA was motivated by some major scandal involving various large corporations. SOA which aims to protect the interests of investors by improving the accuracy and reliability of corporate accounting in accordance with security laws.*

**Key words:** *Sarbanes Oxley Act, transfer pricing policy, corporations, the US*

Along with the increasing power of global corporations, the tendency of the emergence of numerous competitions among corporations also enhanced. Furthermore, this increase is also accompanied by the growing number of privatized state-owned enterprises. For example, at the local and national level, the records show the success of the government in releasing the state-owned company's shares to the public –such as several telecommunications companies– especially to the private companies. At the international level, there are various negotiations conducted in order to enhance the agenda of trade liberalization which facilitated the rise of the corporations. In addition, the talks at the World Trade Organization (WTO) also continue to run, as well as the proposed Free Trade Area in parts of the world continues to unfold. However, several important advancements that are aimed to strengthen the corporations must be accompanied by particular set of rules that allow them to compete and operate fairly. Therefore, the elimination of practices on transfer pricing are commonly used nowadays. In the future, global community must effectively heighten their efforts in order to minimize the frauds conducted by the global corporations and to ensure that their activities support the objectives of creating a high-quality works, a stable community and a healthy competitive environment.

The world now is a single market. Raw materials, labor, and technical skills are coming from all over the world. Similarly, the markets for products and services are also transnational now. This is due to the rapid changes of the business environment, both domestically and globally. These changes require rapid movements of the businessmen in being able to adapt or adjust immediately to the continuous changes in the business environment.

The common traditional systems is proven to be failed in reducing the costs of supporting resources, which then now replaced with a more modern system. The globalization also indirectly

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encourages the spread of conglomeration and departmentalization of the company. In the environment of the multinational corporations, the conglomerates, and departments occur various transactions between members (division), which includes the selling of goods and services, licensing rights and other intangible assets, provision of loans and so forth. In the future, these transactions will make the effort of determining the price to be transferred becomes difficult. Determining the price of various transactions between members or divisions is commonly known as transfer pricing.

The practice of transfer pricing was once done by the company, solely to assess the performance of members or divisions. As the time goes on, the practice of transfer pricing is also often used for tax management as an attempt to minimize the amount of tax to be paid.

### **Transfer Pricing Definition**

For a decentralized organization, the output of a division is used as an input for other division. Transactions between these divisions resulted in the emergence of a transfer pricing mechanism. Transfer pricing is defined as a specific selling price used in the interdivisional exchange to record revenue of the selling division and the cost of the buying division. Transfer pricing is often called as intercompany pricing, intercorporate pricing, interdivisional or internal pricing as the calculated price which is used for the purposes of management control over the transfer of goods and services between members (groups of the company) (Sumamora 1999).

In a working paper issued by the Institute for Fiscal Studies(2003) says:

The interactions between imperfectly co-ordinated corporate income taxes present numerous opportunities for firms to benefit from perfectly legal forms of tax planning. Simple examples include the manipulation of 'transfer prices' for transactions between affiliated companies, with the effect of shifting profits from high-tax to low- tax jurisdictions, and intra-group borrowing and lending, with the effect that interest payments are deducted against corporate tax at a high tax rate in one country and taxed at a lower rate when received in another country. These opportunities for tax avoidance result in lost revenues for governments and add to the perception that corporate tax revenues are under threat.

The purpose of transfer pricing is to transmit financial data between company's departments or divisions in every time they use each other goods and services (Simamora 1999). In addition to these goals, transfer pricing is sometimes used to evaluate the performance of the division and to motivate the managers of selling and buying division to create decisions that in line with overall corporate objectives (Ronen & McKinney, 1970). While at the scope of Multinational Corporation (MNC), transfer pricing is used for minimizing taxes and duties that they spend around the world (Hansen & Mowen, 1996).

### **Transfer Pricing in the MNC**

Generally, MNC wants to achieve two objectives of transfer pricing. First, the performance evaluation. It is one of the tools used by many companies in assessing its performance; as to calculate how much Return on Investment (ROI) they achieved. Sometimes, the level of ROI is different among divisions within the same firm. For example, the selling division wants a higher transfer price to increase income – which will automatically increase its ROI, –while on the other hand, the buying division requires a low transfer prices that would result in increased income, which means also an increase in ROI. This sort of thing, sometimes, creates a dilemmatic situation to determine the right transfer pricing. To overcome this issue, therefore, the head company held a prominent responsibility in determining the transfer pricing. Secondly, Optimal Determination of Taxes occurs due to tax rates differences between countries, which are caused by the economic, social, political and cultural environment in the related country. In Africa for example, since the investment rates is low, the tax rates prevailing in the country are also low. In contrast, it is not possible that the tax rates prevailing in the U.S. is the same as in African countries. The reason is clearly caused by the high level of investments in developed countries, particularly in the U.S., shown by increasing growth rate of the business entity. On this basis, thus, the tax rate prescribed in this country is high.

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A survey conducted by Ernst & Young LLP (1999) found that the problem of transfer pricing is a major problem in the field of taxation for two years up to 2000, which experienced by the MNCs throughout the world. This problem had caused many public accounting firms to do audit compliance in order to examine the problem of transfer pricing that affecting the amount of tax paid.

Transfer pricing is usually set for intermediate products which are goods and services supplied by selling division to the buying division. When examined further, transfer pricing may deviate significantly from the agreed price. Therefore, transfer pricing is also oftenly associated with a systematically engineered prices aimed to reduce the profits, which then reduce the amount of tax or customs must be paid by the country.

The practice of transfer pricing occurs as the investment and trade liberalization happens, as well as the sophisticated communications and transportation technologies increased; so that, today's companies can build a manufacturing plant anywhere as long as the cost of production remains low. As a result, the company's internal trade that associated with productions has also internationally and increasingly fragmented. Between 1982 and 1999, the percentage of exports of the global companies based in the U.S. for their foreign affiliates in the form of goods or semi-finished production rose from 15 to 25 percent. This type of trade offers opportunities for these companies to maximize the loss of subsidiaries in high-tax countries and maximizing the profit in the soft-tax countries. An accounting trick model known as transfer pricing can cause the depletion of income, which would otherwise be used to support the government's agenda on poverty eradication or other social purposes.

Transfer pricing as described by Charles Christian, director of the School of Accountancy at the W. P. Carey School of Business, is a way used by the corporation to distribute some values of the transaction in their books (records). This can be done at several companies who are in their group. However, this practice will not consider as illegal practice when the value of transaction is carried out in their efforts to balance their payments without the having an intention to evade the tax on the profits that they have. This practice often occurs in the U.S..

The exact number of MNCs in the U.S. who have done this kind of transfer pricing practice is indeed unknown. However, in his study of this practice, Christian forecasted that there are so many MNCs who are conducting this practice with different reasons. In his research with Thomas Schultz on the Internal Revenue Service in 2004, he indicated that 67 million dollars of potential tax is exiting the U.S. every year. This happens because many of these MNCs are moving their production assets and some of their valuable transactions through transfer pricing outside the U.S..

Other research conducted by Simon Park and John Zdanowicz (2004) stated that a lot of MNCs who use means of transfer pricing to avoid taxes. Transfer value recorded from their research during 2001 was 53.1 billion dollars. Park and Zdanowicz also found an indication that this value has been increasing since 1998 whose value was 35.7 billion, rising to 42.7 billion dollars in 1999, and reached 44.6 billion in 2000.

Usually, the prevention undertaken by countries towards the practice of transfer pricing is to create an authority that allows the government to reallocate the amount of profit and costs incurred in the MNCs which always have a multi-divisions. Thus, the profit and costs arising as a result of transactions between divisions, which are suspected as a practice of transfer pricing and potentially minimizing tax, can be prevented.

In the U.S., the MNCs are also the main target of government policy towards the minimization of transfer pricing practices set forth in Internal Revenue Code Section (IRS) 482 regarding pricing of intercompany transactions. This article gives the IRS the authority to reallocate the income or profit and costs between divisions if there are indications that the transaction can potentially reduce their tax payments (Hansen and Mowen, 1996). Further confirmed in the IRS, in case of transactions between divisions inside the MNCs or the transaction between companies with a particular relationship, the current price is the price that arises when the transaction is conducted by parties outside the company or in other words, the transaction conducted by parties who do not have a special relationship (Hansen and Mowen 1996).

The value, volume and complexity of transactions that occur within the global context create a challenge for business management and tax administration. Commissioner Harvey Goldschmid of the U.S. Securities and Exchange Commission (SEC) in his speech "Post-Enron America: A SEC Perspective", at the Fordham University School of Law in 2002, claimed at least there are systemic failures in the implementation of Corporate Governance in the U.S.. Checks and balances that had

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been considered to be provided by independent directors, auditors, securities analysts, investment bankers, and lawyers, too often fails. According to him, good governance depends on the directors and senior managers to know what the tax risks are and to ensure that they are well managed, like any other material risks to the corporation. Meanwhile, the Tax Office does not expect the directors and senior managers to be a tax expert. Whereas in the Sarbanes Oxley Act recommended that the directors and senior managers can bring independent judges for each proposal, as an advisory approach to prevent a reckless or aggressive decision on taking the unexpected tax risk of the company ([http://www.ato.gov.au/corporate/content . asp? doc = / content/79095.htm](http://www.ato.gov.au/corporate/content.asp?doc=/content/79095.htm), January 13, 2011).

Recognizing the increasing number of transfer pricing practices that might cause an exiting potential tax revenues to other country, the U.S.government then began to establish a rule to govern the companies that are registered in the U.S. stock market. The regulation is known as the Sarbanes Oxley Act that was officially passed in 2002 by George W. Bush. This becomes the legal basis that governs the rules and standards implementation of the application of Corporate Governance in the U.S..

### **Sarbanes Oxley Act**

Sarbanes Oxley Act (SOA) is a law in reporting and governing the company with the U.S. standards. SOA requires companies that listed in U.S. stock markets to comply with a number of existing rules to ensure a greater certainty towards the integration of a financial statement (<http://www.bappenas.com>). There are 11 titles and 66 sections in the SOA. However, not all of them have to be adopted by a company listed in the New York Stock Exchange (NYSE). Companies can adopt particular sections that in line with its internal systems used.

The law was initiated by Senator Paul Sarbanes (Maryland) and Representative Michael Oxley (Ohio), and was signed by President George W. Bush on July 30, 2002. The law was issued as a response of the U.S. Congress on various scandals at several large corporations such as Enron, WorldCom (MCI), AOL TimeWarner, Aura Systems, Citigroup, Computer Associates International, CMS Energy, Global Crossing, HealthSouth, Quest Communications, Safety-Kleen and Xerox; which also involves some Public Accountant Offices (PAO) who issued their audit results. All of these scandals are the example of how fraudulence gives a devastating impact on the market, stakeholders and employees.

With the issuance of this law, coupled with the implementation of some rules of the implementation of Securities Exchange Commission (SEC) and several other self-regulatory bodies, it is expected to raise the standard of corporate accountability, transparency in financial reporting, minimalization of the possibility for companies or organizations to conduct and conceal fraud, and maintain a high attention on the corporate governance. Currently, corporate governance and internal control is no longer considered as something strange as both of them have been required by law.

In the SOA, a set of rules on accountancy, disclosure and governance reforms is regulated; that requires more disclosure of financial information, a description of the results achieved by the management, code of ethics for officials in the fields of finance, executive compensation restrictions, and establishment of an independent audit committees. In addition, it also regulates the following matters: (1) establishing some new responsibilities to the board of directors, audit committees and managements, (2) establishing the Public Company Accounting Oversight Board, an independent board and works full-time for the capital market participants, (3) adding the SEC's responsibilities and significant budgets, (4) defining the 'non-audit' services that should be given by the PAO to clients, (5) increasing the penalties for corporate fraud, (6) requiring the existence of set of rules on how to deal with conflict of interests, and (7) setting some new reporting requirements.

The company or organization that is governed by SOA is: the companies whose shares have been registered under Section 12 of the Exchange Act of 1934, the companies who are obliged to make a report registered under Section 15 (d) of the Exchange Act, the companies that are in the process of registration, and POAs that issued the audit reports. This Act does not exclude foreign companies that are listed in the U.S. and POAs from outside the U.S. that issued the audit reports for the related companies.

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## **The Impact of SOA for the U.S. Companies**

As explained above, the emergence of the SOA was motivated by some major scandal involving various large corporations. SOA which aims to protect the interests of investors by improving the accuracy and reliability of corporate accounting in accordance with security laws.

This regulation becomes the most comprehensive law in terms of setting corporate law since 1930 (Kotler 2003). This is also confirmed by Bush's statement that emphasized that this rule is to reform U.S.' most phenomenal business practices since Franklin Delano Roosevelt ([www.wlf.org](http://www.wlf.org), January 12, 2010). Indeed, this rule has penetrated areas that have not been regulated in detail by previous legislation. The law covers detailed matters which includes the role of POAs to corporate governance. Kotler also stated that this rule changes the rule of conduct of the U.S. corporate governance that previously was extremely flexible to a very rigid and detailed one.

In particular, SOA puts new limits on three categories of corporate governance. First, Congress is prohibited from making a transaction with the corporations, officials, as well as the ranks of directors, as listed in Article 402 SOA. Second, the Act also prohibits a public company to give private loans to its executives; it is stipulated in Article 306. This is done by imposing an internal control system and makes a report in each year in accordance with Articles 406 and 407 of the SOA. The proper body to run this process is the audit committee whose members are experts in finance. Third, the Article 304 of SOA requires the Chief of Officer (CEO) of public companies to prepare accounting reports under Securities Law. Therein shall contain such things as (1) any bonus should be based on the incentive compensation, and (2) all the profits from the stock market will be re-checked whether the benefits is really profitable or not to shareholders or the company.

The impact of SOA implementation on the companies and large corporations in the U.S. is not simple. Many fundamental and detail matters are needed to be fixed in order to meet the requirements set forth in the SOA. Kotler (2003) in his review on the impact of the SOA implementation mentioned that there are at least some fundamental things that should be done by most companies in the U.S.. First, he mentions that with the very significant set for corporate governance, they must reconstruct its internal structure. Even the company might have to change their ranks of commissioners and directors, hire a new accountant, and follow other procedural guidelines. This certainly will increase the cost of managing the company and, certainly, will indirectly impact on stakeholders and their shares. It can be said that in addition to the impact of transparency and corporate governance standardization, there is another negative effects namely the inefficiency costs. While this is indeed necessary to prevent practices of irregularities and fraud, but the problem of inefficiency for a corporation cannot be underestimated. For some, this will be a new burden, not only to the company executives, but also to the stakeholders and shareholders.

Next, in regard to the single standard set in the SOA towards all the companies listed in the U.S. stock markets, it impose the same standards for all companies, whether they have high capability or low, many or few assets. This type of a rigid standard, sometimes, is a problem for companies that have a large scale or which are new ([www.wlf.org](http://www.wlf.org), January 13, 2011). The consequence to be faced due to this problem is the increasing number of capital flight out of the U.S. ([www.gj.com/files/Publicatio/SpecialReportITIC-OEF-SSDIntnTaxesPaperEng.pdf](http://www.gj.com/files/Publicatio/SpecialReportITIC-OEF-SSDIntnTaxesPaperEng.pdf), January 13, 2011).

## **SOA and the Transfer Pricing Practices**

The SOA 2002, especially Article 404 has a very significant impact on the implementation of the corporate governance in the U.S. companies. In this Article, it is mentioned that the external auditors' job is not only to audit the financial reports, but also other things related to the governance model and the effectiveness of internal controls. At this level, all matters related to financial audits should also be based on regulatory standards within the Article, just as the practice of transfer pricing that could impact on the amount of tax paid by the company.

The evaluation process of transfer pricing practices uses the perspective of SOA Article 404 has fundamental differences with the previous audits model. In a basic level, this audit system does not include the transfer pricing case exclusively, but sees it as a point that might impact the financial statements. Regarding to this matter Jon Silverman, Phil Carmichael and Thomas Herr said in their

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review that the control of transfer pricing practice consists of five steps, namely (1) identify of all materials and documents that record every transactions between firms, (2) identify the document policies and controls that apply to any material transactions of transfer pricing, (3) implement the procedures to ensure that transfer pricing policies and controls are applied, (4) measure the potential impact of transfer pricing along with its tax payer, and (5) mitigation of risk. These five stages are the controls associated with the main financial audits, such as the goal of completion of each stage, the main risks and control activities.

Documentation of SOA Article 404 (S/O 404) was prepared for very different reasons from the study of tax-related documentation that related to the previous tax which has an overlap between the two periods. Besides, the S/O 404 can assist the development of efficient tax documentation. Initially, the transaction identification will be required which may have a significant impact on the financial reports. Thus, the S/O 404 process should help the company in the effort of prioritizing their documentation to be more effective than ever before; greater resources should be allocated to deal with the greatest possible impact. What needs to be considered further is that the determination of material transactions is not just about seeing the volume of transactions per se. Material transaction, from the perspective of transfer pricing and tax are those transactions that have the potential to create significant risk adjustment (i.e., the risk of re-allocation of income by the tax authorities). Therefore, even very large transaction does not appear to pose a material risk if the transaction price cannot be successfully challenged by tax authorities, or where any adjustment will have limited consequences of financial reporting.

As for some factors that determine the potential risk of inter-company transactions of financial reporting by Jon Silverman, Phil Carmichael and Thomas Herr are: (1) the difficulty to determine the price of the dependency for a given transaction: especially in the practice of transfer pricing, (2) an adjustment to the tax consequences, of which is the case where there are differences in marginal tax rates between jurisdictions involved in the transaction: the higher the level, the greater the difference in the adjustment impact, and (3) the availability of double tax relief – where any major adjustments that could have a material impact if tax breaks double – is not provided.

The first factor is affecting the magnitude of the potential adjustment with respect to the size of the underlying transactions. For example, the cost of intangible value may be unique, subject to adjustment by 50 percent or more of the real value allocated. On the other hand, the price of widely traded products which cannot be adjusted by more than 5 percent, assuming that normal adjustment is possible. The second and third factors influence the differences in tax rates that will apply for the adjustment. If the adjustments are made by the tax authorities on a high-tax jurisdiction for any transactions with tax-jurisdiction, or, if there is no double tax relief is available, the difference in interest rates may be similar to high-tax jurisdictions.

Second, the S/O 404, in the process, is to identify and address issues that are often overlooked in the studies of traditional documentation. Several possibilities may occur in this process. First, the taxpayers often make a late adjustment to bring them to the longer term after the use of comparable price / margin with net margin transaction method. Meanwhile, in order to solve the problem of transfer pricing, it is also quite risky that other issues may rise if these settings are not deductible in another country. A process that ensured effective in the S/O 404 is to ensure agreement and procedures to increase the likelihood that they will reduce in place before the adjustment. This process should also include controls that ensure that staff who conduct the research or transfer price adjustments is qualified to do so as well as on the review of the process for the work performed, especially in cases where the documentation is completed locally without central supervision. Two different studies covering the same transaction can reach very different conclusions about the methods and functions. For example, a study in France can conclude that France distributors are the party being examined and did not qualify. While the studies in the U.S. can conclude that the U.S. manufacturers are the party being tested and fit the criteria. In S/O 404 procedures, at least for large transactions, it supposes to explicitly specify both these policies are applied and is expected to encourage the consistent development of transfer pricing documentations.

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S/O 404 also resulted in the identification of accounting issues that may affect the compliance with transfer pricing practices. Oftenly, the companies have accounting systems that provide precise accountability based on the multi-standard cost, though, it does not provide the proper monitoring of inter-company profits. In such circumstances, there are significant differences between what transfer pricing policies are implemented and what way are used in the inter-company accounts. S/O 404 includes a procedure to detect any accounting policies that undermine the company's ability to effectively implement a transparent accounting system.

## **Conclusion**

The compliance with the SOA can be tricky, especially for corporations that have used a relatively long approach to monitor transfer pricing. The process requires a systematic and rigorous implementation in order to be able to identify material transactions and to ensure that taxpayers do not only have the correct transfer pricing policy, but also to ensure this policy is followed. In the end, the policy chosen should be able to identify and lead to a better understanding of the risks and a greater ability to develop appropriate documentations, taking into account the specific risks and the parties involved.

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