Consumer Federation of America

February 14, 2005

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket No. 017

Dear Board Members:

I am writing on behalf of the Consumer Federation of America[1] in strong support of the proposed rules to promote auditor independence. While there are areas where we believe the proposed rules can and should be strengthened, prohibiting auditors from providing the most troubling types of tax services to audit clients, enhancing the ability of the audit committee to offer appropriate oversight, and prohibiting auditors from accepting contingent fees are all necessary steps that should significantly enhance the independence and integrity of the audit process.

The Need for Further Regulation of Tax Services

When Congress adopted its limits on non-audit services as a part of the Sarbanes-Oxley Act, considerable discussion focused on the area of tax services. Certain tax services, such as the preparation of tax returns, were almost universally viewed as acceptable. Others, such as the sale of tax shelters, were almost universally recognized as creating unacceptable conflicts. Opinion on other services, such as other forms of tax planning, was more divided. Rather than try to draw the line between permissible and non-permissible tax services in legislation, Congress delegated that responsibility to audit committees, who were given a clearer mandate to protect the independence of the audit by, among other things, pre-approving all non-audit services. Congress also reserved for the PCAOB the right and responsibility to enact additional independence and ethics rules as needed.

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[1] The Consumer Federation of America (CFA) is a nonprofit association of 300 consumer groups, representing more than 50 million Americans. It was established in 1968 to advance the consumer interest through research, education, and advocacy.

Unfortunately, in drawing up the rules to implement the legislation, the Securities and Exchange Commission sent mixed signals that helped to muddy the waters on these important issues. For example, despite Congress's steadfast refusal to amend the legislation to permit pre-approval of non-audit services through policies and procedures, the Commission granted audit firms that concession during the rulemaking process. In addition, the Commission removed from the final auditor independence rule release language from the proposing release that drew attention to potential conflicts of interest associated with certain types of tax services and encouraged audit committees to evaluate such services carefully in light of the previously enumerated principles for determining auditor independence.

We are aware of subsequent efforts by at least one major audit firm to use these concessions to undermine the rigor of the audit committee pre-approval process. In guidance provided to audit committees on their responsibilities under the new law, this firm implied: that the SEC had determined that the basic principles of auditor independence were too vague to be useful to audit committees in evaluating non-audit services; that tax services, with the exception of the sale of tax shelters, were generally viewed as non-controversial; and that most audit-related and tax services could be approved annually based on a minimal review.[2] While the Commission has since issued guidance that should help to counteract these misleading messages, it is not clear that all audit committees have carefully reviewed and are following that guidance.

Other developments since the SEC's auditor independence rules were released have drawn attention to the need for stricter limits in the area of tax services. These include:

- revelations that Sprint fired its two top executives, rather than dismiss its auditor, because of conflicts resulting from the auditor's highly lucrative sale of controversial tax shelters to those executives;

- release of the official report of the Joint Committee on Taxation on its investigation into the collapse of Enron, which laid out the substantial role that promoters of and advisers on tax strategies played in the downfall of that company (along with subsequent evidence of similar problems at Worldcom and Qwest);

- continuing problems with abusive sales of tax shelters by major audit firms; and

- continued efforts by some audit firms to evade SEC rules prohibiting the use of contingent fee arrangements.

Taken together, these developments make a compelling case for further regulation and clarification in this area.

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[2] These concerns are described in greater detail in a June 4, 2003 letter from Barbara Roper, Consumer Federation of America, Edmund Mierzwinski, U.S. Public Interest Research Group, Sally Greenberg, Consumers Union, Kenneth McEldowney, Consumer Action, and Chellie Pingree, Common Cause, to SEC Chairman William Donaldson.

PCAOB's Rule Proposal

The PCAOB lays the groundwork for its independence rules by first establishing, in proposed Rule 3520, that registered accounting firms have an obligation to maintain their independence from the audit client throughout the audit and professional engagement period. We believe this is an important and useful standard for the Board to establish. While we support proposed Rule 3520, as far as it goes, CFA urges the Board to strengthen the rule, first, by including the four basic principles for auditor independence in the rule and, second, by clarifying that audit firms have an obligation to maintain the appearance, as well as the reality, of independence. Codifying these standards would serve a useful purpose, by unambiguously establishing the basis on which decisions about the permissibility of non-audit services are to be made both by auditors and by audit committees.

The PCAOB further lays the groundwork for its independence rules by establishing, in proposed Rule 3502, that associated persons may not cause the firm to violate the Sarbanes-Oxley Act, the rules of the Board, or the provisions of the securities laws relating to the preparation and issuance of audit reports. Because CFA believes it is imperative that the Board have clear authority to act not just against firms, but also against the individuals associated with firms, we strongly support proposed Rule 3502.

Independence Violations

The PCAOB then establishes three types of conduct related to tax services that would compromise an auditor's independence: entering into a contingent fee relationship with an audit client; providing assistance in planning, or providing tax advice on, certain types of potentially abusive tax transactions; and providing any tax services to certain senior officers of an audit client.

Contingent Fees: Accepting payment in the form of contingent fees – for example, a percentage of any tax savings generated by the auditor – creates a mutual interest between the auditor and audit client. As such, it is a clear violation of the basic principles of auditor independence. Frankly, we view it is evidence of the cavalier attitude audit firms have all too often shown toward their independence obligations that they would even contemplate entering into such an arrangement, let alone actively seek to evade SEC rules. We therefore strongly support proposed Rule 3521 prohibiting auditors from accepting contingency fees or commissions from audit clients either directly or indirectly. It offers a welcome supplement to recent steps taken by the SEC to enforce and clarify its own rules in this area. Furthermore, we believe the proposed definition of contingent fee is an improvement over the SEC definition, since it deletes the language that has been, at best, confusing and, at worst, a means of evading the SEC rules.

Aggressive Tax Positions: Proposed Rule 3522 would, in effect, prohibit auditors from marketing or advising on abusive tax avoidance transactions. Abusive sale of tax shelters calls into question the ethics of audit firms, in addition to the independence concerns associated with their sale to audit clients. When the tax shelters are sold to audit clients, or when the audit firm advises the client on the tax implications of the strategy, it is all but inevitable that the auditor

will be forced to audit issues directly related to that transaction. Clearly, in such circumstances, the auditor's independence is compromised.

We therefore generally support the restrictions outlined in this proposed rule. In particular, we support the inclusion of aggressive tax positions and confidential transactions, along with listed transaction, in the prohibition. However, we do not believe the prohibition related to aggressive tax positions should be limited to those initiated by the audit firm or another tax advisor. Regardless of who originates the transaction, the auditor is likely to have to examine it as part of the audit, thus creating independence concerns. Furthermore, structuring the rule in this way seems likely to invite efforts to circumvent it. Finally, simply requiring the audit firm to obtain a third party opinion would not resolve this problem, since such opinions have apparently been offered "for sale" by various parties to support the marketing of such strategies.

Tax Services for Senior Officers in a Financial Reporting Oversight Role: As the relatively recent case involving Sprint makes clear, auditors' independence is called into question when they offer tax advice to executives audit clients. This may occur because it creates a mutual interest between the auditor and the executives, and one that may conflict with the interests of shareholders, or because the fees associated with sale of tax shelters to these executives are so large they undermine or appear to undermine the willingness of the audit firm to stand up to those executives when reviewing the financial statements. As a result, we strongly support proposed Rule 3523. However, we believe its provisions should be extended to cover a broader population. At the very least, it should cover those directors who serve on the audit committee, given their responsibility under Sarbanes-Oxley to hire, compensate, and oversee the auditors.

Audit Committee Pre-Approval of Tax Services

Finally, the PCAOB has proposed Rule 3524 to strengthen the obligations of auditors in seeking audit committee pre-approval of tax services. We believe this is an area greatly in need of attention, and we strongly support the proposed rule. By requiring the auditor to provide the audit committee with detailed documentation of the nature and scope of the proposed tax service, to discuss the potential effects of performance of these services on the firm's independence, and to document its discussion, this rule should help to ensure that audit committees have the information they need to fulfill their pre-approval obligations. Ideally, this should involve providing the audit committee with the engagement letter that includes a description of the services to be provided and the fees to be paid for those services. In fact, it seems impossible to us that audit committees could fulfill their obligations without receiving this information. Finally, requiring documentation of the discussion should ensure that audit firms treat these issues appropriately and do not simply gloss over or downplay any independence concerns.

Conclusion

CFA was among those who urged Congress to go further than it ultimately did in restricting the non-audit services auditors are permitted to provide to audit clients. Specifically, we argued that auditors should be limited to providing those non-audit services that can be shown to offer clear benefits to shareholders. This continues to be the standard we believe

should be applied to all non-audit services, including tax services. Using such a standard, we believe auditors should also be prohibited from providing any tax planning services that might require the auditor to audit its firm's own work. We also believe auditors should be prohibited from providing expatriate tax return work, which can involve substantial fees and which has been associated with certain recent violations of SEC independence rules. Finally, we believe audit committees should be encouraged to adopt this standard of approving only those services that benefit shareholders and should be required to disclose to shareholders the basis for their view that the service is beneficial.

The PCAOB rule proposal stops well short of adopting this approach in evaluating tax services. Despite these short-comings, it nonetheless offers important progress toward enhancing auditor independence, by restricting the ability of auditors to provide those tax services that have been identified as being of greatest concern and by improving the ability of audit committees to fulfill their pre-approval responsibilities. We commend the PCAOB for giving this issue early and thorough consideration. We urge prompt adoption of these rules with the above suggested strengthening amendments.

Respectfully submitted,

Barbara Roper
Director of Investor Protection