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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006

Members and Staff of the Public Company Accounting Oversight Board:

Deloitte & Touche LLP is pleased to respond to the request for comments from the Public Company Accounting Oversight Board ("PCAOB" or "the Board") on its *Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, PCAOB Release No. 2004-015, PCAOB Rulemaking Docket Matter No. 017 (December 14, 2004) (the "Release").

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I. Introduction

We appreciate the opportunity to submit these comments to the PCAOB. Deloitte & Touche LLP strongly supports the goals of the Sarbanes-Oxley Act ("Act") and the efforts of the PCAOB to achieve those goals through rulemaking. We are committed to working with the PCAOB to achieve effective implementation of the Act and strongly agree with the measured and balanced approach set forth in the Release. Furthermore, we recognize that the Board faces difficult and sensitive judgments in crafting this proposal. We hope that these comments will be helpful to the Board in drafting and implementing final rules.

In that spirit, set forth below are our comments with respect to the Release. We first offer some general comments regarding the unique status of tax services provided by audit firms, and then provide specific comments to the proposed rules in sequential order. Throughout this document, we have sought to respond to the specific questions posed in the Release. We support the proposed rules' core provisions, including prohibiting contingent fee arrangements and limiting certain "aggressive" tax services, and believe that these rules strike the right regulatory balance. In order to avoid unintended consequences and the need for further clarification, we have in some instances suggested alternative approaches that we believe will serve the PCAOB's goals, and further the effective and efficient implementation of, compliance with, and enforcement of these rules for registrants, audit committees and practitioners.

II. General Comments

A. Regulation of Tax Services

As set forth below, and as the Release acknowledges, Congress and the Securities and Exchange Commission (the "Commission") have both scrutinized tax services provided by accounting firms to their audit clients and have concluded that they are generally beneficial to issuers and investors and pose little risk to independence.[1] Moreover, Congress created an audit committee pre-approval process for non-audit services, including tax services, to further protect independence. To the extent subsequent developments require additional guidance within the context of regulating tax services, the PCAOB has the authority to adopt appropriate regulations.[2] Given this background, we provide the following general comments to the proposed rules. These general comments focus on the beneficial effects of tax services provided by an audit firm on the overall quality of an audit, and a continued focus on the effective use of audit committees to oversee and pre-approve such services.

1. Regulation In Light of the Unique Status of Tax Services

Tax services are afforded a unique status under the Act and the related securities laws. The provision of tax services by accounting firms to their audit clients, and their affiliates and officers, has been carefully considered by Congress and the Commission and determined not to create an independence issue requiring regulatory prohibition. As the Commission has

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[1] Release at 6-7.

[2] *Id.* at 8-9.

explained, "[t]ax services are unique . . . for a variety of reasons."[3] Among those reasons, "[d]etailed tax laws must be consistently applied, and the [IRS] has discretion to audit any tax return. Additionally, accounting firms have historically provided a broad range of tax services to audit clients."[4]

"The provision of tax services by accountants to their audit clients existed and continued without change when Congress formulated the securities laws in the 1930's."[5] Since then, neither Congress nor the Commission has prohibited traditional tax services. Under the Commission's 2000 rules, "Strengthening the Commission's Requirements Regarding Auditor Independence," accounting firms are permitted to provide tax services to their audit clients, without any deemed impairment of auditor independence. Recognizing "that not all non-audit services pose the same risk to independence," the Commission concluded that "tax services generally do not create the same independence risks as other non-audit services."[6] This judgment was the product of a deliberative process, in which "over 100 persons testified, a Congressional hearing was held, and over 3,000 comment letters were received."[7]

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[3] Strengthening the Commission's Requirements Regarding Auditor Independence; Final Rule; 68 Fed. Reg. 6006, 6017 (Feb. 5, 2003).

[4] *Id.*

[5] *Id.* at 6017 n.103.

[6] Revision of the Commission's Auditor Independence Requirements; Final Rule; 65 Fed. Reg. 76008, 76010, 76052 (Dec. 5, 2000).

[7] Strengthening the Commission's Requirements Regarding Auditor Independence; Proposed Rule; 67 Fed. Reg. 76780, 76784 (Dec. 13, 2002).

The Act itself explicitly permits accounting firms to provide tax services to their audit clients. Tax services are not among the list of prohibited non-audit services contained in Section 201 of the Act.[8] Further, Section 201 explicitly states that accounting firms "may engage in any non-audit service, *including tax services*, that is not described" in the list of prohibited non-audit services, and that is pre-approved by the audit committee.[9] Notably, tax services are the only non-audit service singled out for explicit legislative approval.[10]

The Act's legislative history confirms that Congress intended that accounting firms could continue to perform tax services for audit clients. A provision in the Sarbanes bill that would have required the Commission to adopt rules that went beyond the Commission's 2000 scope of services rule was deleted.[11] As one member of the Senate Banking Committee observed, that deletion meant "we will live under the current rules."[12] Chairman Oxley later underscored that Congress did not intend for the Act to be interpreted as restricting accounting firms from providing tax services to audit clients. He noted that tax services are not prohibited under the

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[8] Act, § 201.

[9] *Id.* (emphasis added).

[10] *Id.*

[11] *See* Sen. Amend. No. 4216, 107th Cong. (2002).

[12] *Markup on the Public Company Accounting Reform and Investor Protection Act of 2002 Before the S. Comm. on Banking, Housing and Urban Affairs*, 107th Cong. 34 (2002) (unofficial transcript dated June 18, 2002) (statement of Sen. Bunning).

Act because "[t]here was no evidence in [Congress's] hearings that indicated that the tax function was untoward or somehow led to fraud."[13]

In its 2003 rulemaking intended to further strengthen auditor independence and implement Title II of the Act, the Commission "reiterate[d] its long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence."[14] The Commission stated that the Congressional intent behind allowing tax services "would appear to be that auditor independence is not impaired by an accountant providing traditional tax preparation services to an audit client or an affiliate of an audit client."[15] "Nothing in the proposed rules," the Commission continued, "is intended to prohibit an accounting firm from providing tax services to its audit clients when those services have been pre-approved by the client's audit committee."[16] Accordingly, the Commission determined that, subject to audit committee pre-approval required under the Act, "accountants may continue to provide tax services such as tax compliance, tax planning, and tax advice to audit clients."[17]

In light of the unique nature of tax services, the historical reliance of audit clients on their audit firms to provide tax services, and actions by Congress and the Commission that serve to

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13 Bloomberg News Service, *Oxley Says Governance Law Does Not Seek to Ban Tax Services* (Dec. 9, 2002). *See also* Richard Y. Roberts, *The Sarbanes-Oxley Act of 2002 Does Not Prohibit Auditors From Offering Tax Services To Audit Clients*, THE TAX EXECUTIVE, Sept./Oct. 2002 (discussing the Act's legislative history with respect to tax services).

14 68 Fed. Reg. at 6017.

15 67 Fed. Reg. at 76790.

16 *Id.*

17 68 Fed. Reg. at 6017.

preserve the provision of tax services in this context, we believe that careful consideration should be given before adopting rules that serve to limit the provision of tax services by accounting firms to their audit clients, thereby preserving the existing beneficial, complementary relationship between audit and tax services.

2. Focus on Audit Committee Pre-Approval Processes To Regulate Tax Services

We believe that, outside of specific tax services that the proposed PCAOB rule would prohibit, the primary mechanism for regulating an audit firm's provision of tax services should remain with the audit committee, exercising its authority through the existing pre-approval regime. Ensuring that audit committees receive adequate disclosure as to the facts and circumstances surrounding all tax services provides the necessary checks and balances to preserve auditor independence. Audit committee oversight and pre-approval are also effective methods to prevent potentially aggressive tax services.

Congress has expressed its support for the pre-approval regime for non-audit services in general, and for tax services specifically. As noted above, Section 201 of the Sarbanes-Oxley Act states that registered public accounting firms may engage in any non-audit service, specifically including and uniquely identifying "tax services," that is not listed by the Act as a prohibited service and that is pre-approved by the audit committee.[18] Congress therefore recognized that audit committees are well equipped to consider the propriety of the engagement of an audit firm to provide tax services.

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[18] Act, § 201(a).

Following passage of the Act, the Commission affirmed Congress's expectation that the audit committee would have significant responsibility for governing the provision of non-audit services by a company's audit firm. In explaining its proposed rules to strengthen its auditor independence requirements, the Commission made clear that its rules would not upset the regulatory balance struck by Congress: "Nothing in these proposed rules is intended to prohibit an accounting firm from providing tax services to its audit clients *when those services have been pre-approved by the client's audit committee*."[19]

Continued reliance on audit committees not only implements the Congressional mandate—it also makes practical sense. Audit committees are uniquely situated to make case- and fact-specific determinations regarding the appropriateness of tax services. Indeed, audit committee pre-approval is working, even though it has been in existence for only a brief period.[20] We support the ongoing commitment to audit committee oversight of auditor independence, and we are encouraged by the effectiveness, competence and good faith being demonstrated by audit committees based on our experience in the marketplace.

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[19] 67 Fed. Reg. at 76790 (emphasis added).

[20] *See*, *e.g.*, Release at 40-41 (deferring to the "judgment" of audit committees and foreswearing any "rigid, mechanical application" of any pre-approval "framework"); Unofficial Transcript of PCAOB's Auditor Independence Tax Services Roundtable (July 14, 2004) at 75, *available at* http://www.pcaobus.org/rules_of_the_board/documents/2004-07-14_roundtable_ transcript.pdf (last visited Jan. 31, 2005) ("Roundtable") (Colleen Sayther, Financial Executives International) ("the current process of having the audit committee vet those tax services and make a determination as to what's appropriate and what's not appropriate is the way to keep it.").

3. The Benefits of Tax Services Provided By an Issuer's Audit Firm

We support rules that provide issuers the ability to procure tax services that are both permissible and beneficial to issuers and investors. The tangible benefits arising from tax services provided by audit firms are numerous and well-recognized. Tax services are a natural extension of the audit process and aid the quality of the audit itself.[21] A broad understanding of a company's tax posture reinforces audit quality. Where an audit firm is not permitted to perform tax services, that firm's ability to understand a company's tax transactions for purposes of the audit is much more difficult. Conversely, appropriate tax positions should be firmly rooted in the business activities of a company. As such, an audit firm's intimate knowledge of an issuer's business aids in providing high quality tax advice.

We also believe that audit committee consideration of tax services represents sound corporate governance. Because of their role in pre-approving tax services provided by their audit firm, audit committees are better equipped to understand and oversee all of the issuer's tax related activities and any associated risk. Tax services provided by an audit firm—as opposed to another tax advisor—are also more transparent to the public, in that the fees from tax services provided by the issuer's audit firm are disclosed to investors in Commission filings.[22] By

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[21] *See* William R. Kinney, Jr. – University of Texas at Austin, Zoe-Vonna Palmrose – University of Southern California, and Susan Scholz – University of Kansas, *Auditor Independence and Non-audit services: What do Restatements Suggest*, April 17, 2003 (study results consistent with a view that tax services provided by the issuer's audit firm improve audit quality).

[22] *See* Act, § 202 (adding subsection (i)(2) to 15 U.S.C. § 78j-1).

contrast, tax services provided by other advisors may not be subject to the same level of transparency.[23]

B. Transition Rules

The Release proposes an effective date that is the later of October 20, 2005, or 10 days after the Commission approves its rules.[24] However, given the nature of tax services, we believe that a detailed set of transition rules is required. For example, transition rules are necessary to accommodate certain corporate transactions, including, but not limited to, initial public offerings and mergers and acquisitions, whereby a company's status as an "audit client" may change in ways that do not coincide with tax years. Similarly, transition rules should be tailored to the definition of "audit and professional engagement period" (e.g., to facilitate the provision of tax services when a registered firm provided tax services to an issuer before becoming the issuer's auditor; or when a registered firm has ceased being an issuer's auditor but still has on-going obligations resulting from its prior status as auditor). Throughout the next section of specific comments, we have identified additional examples that demonstrate the need for robust transition rules, and we are hopeful that the PCAOB will consider these examples when drafting final rules.

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[23] *See*, *e.g.*, Unofficial Roundtable Transcript at 45-49 (discussing the transparency of auditor-performed tax services).

[24] Release at 43.

III. Specific Comments

A. Proposed Rule 3502: Responsibility Not To Cause Violations

We agree with the PCAOB that associated persons should not violate the Act or related rules, but have concerns about the breadth of Proposed Rule 3502. Proposed Rule 3502 would expose an associated person to discipline for "negligently" "contributing" to a firm's violation of any one of a number of complex securities laws, rules and regulations, and professional standards.[25] For a variety of reasons, we strongly believe that negligence is not the appropriate standard for imposing liability on an associated person for the conduct of his or her firm. We do not believe that the PCAOB should adopt the rule in its current form, but instead should adopt a "knowing," intentional standard and clarify all remaining ambiguities.

Negligence Standard. Application of a negligence standard to the conduct of individuals covered by the proposed rule would cause tension with the larger Congressional scheme, and would be unfair, unworkable, and legally suspect.

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[25] Proposed Rule 3502 provides:

> A person associated with a registered public accounting firm shall not cause that registered public accounting firm to violate the Act, the Rules of the [PCAOB], the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards, due to an act or omission the person *knew or should have known would contribute* to such violation.

Id. at A-4-Rule (emphasis added). As the PCAOB states, the "knew or should have known" standard "is intended to articulate a negligence standard." *Id.* at 18 n.40; *see also* PCAOB, Open Meeting Tr. at 36 (Dec. 14, 2004) ("The standard is simple negligence, and it does not require . . . the proving of a number of specific elements in order to establish the offense or the violation.").

As an initial matter, we believe that the adoption of a mere negligence standard presents several legal questions. Courts have cautioned against imposing greater liability on persons who participate unintentionally in questionable conduct, than on those who are the witting principal actors.[26] Proposed Rule 3502, however, would create a "negligence" standard for individual accountants or firm employees at the same time the firm itself—the entity the behavior of which would actually trigger Proposed Rule 3502 by violating the securities laws, related rules and regulations, or professional standards—is subject to a higher standard of intent for various violations within the PCAOB's regulatory authority. For example, when a firm, during the preparation of an audit report, "detects or otherwise becomes aware of information indicating that an illegal act . . . has or may have occurred," the securities law requires that the firm consider the need to undertake a series of specific measures that ultimately may result in furnishing a copy of the report to the Commission ("Section 10A(b)").[27] Firms that "willfully violate[]" Section 10A(b) may be subject to a civil penalty.[28] It would be incongruous for the PCAOB to impose liability on an individual who somehow "negligently" "contributed" to a

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[26] *See*, *e.g.*, *Investors Research Corp. v. SEC*, 628 F.2d 168, 177 (D.C. Cir. 1980) (stating, in the context of "aiding and abetting" liability, that a non-principal should not be subject to a lower standard of culpability than a principal because "innocent, incidental participants in transactions later found to be illegal are not subjected to harsh, civil, criminal, or administrative penalties").

[27] Securities Exchange Act of 1934, § 10A(b).

[28] *Id.* at § 10A(d).

substantive violation that, like this one, that can only be committed through willfulness.[29] The Release implicitly acknowledges the potential incongruity of this disparity.[30]

Congress, in any event, may not have authorized the use of a negligence standard as broad as the one set forth in the proposed rule. Section 105(c)(5), which is entitled "Intentional or other Knowing Conduct," states:

> The [PCAOB's] sanctions and penalties described in subparagraphs (A) through (C) and (D)(ii) of paragraph (4) [of Section 105(c)] shall *only* apply to—
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> (A) intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory or professional standard; or
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> (B) repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard.

(Emphasis added). On the other hand, Section 105(c)(5) does not specify standards of intent for certain other sanctions authorized under Section 105(c)(4).[31] This comparative statutory silence could be read to permit a "negligence" standard for those other sanctions. But Proposed Rule

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[29] There are virtually unlimited ways in which an individual's actions could be deemed to "negligently" "contribute" to such a violation. In the Section 10A(b) example, an engagement team member could misread or misinterpret information that is shared with others on the engagement team; that mistake could later be deemed to have "contributed" to another team member's separate, willful decision not to provide a copy of the report to the Commission.

[30] *See* Release at 19 (questioning whether it would be "appropriate" to find a Rule 3502 violation by an associated person who *negligently* contributed to the violation, in a circumstance in which finding a violation by the firm "requires that the firm knowingly or recklessly engaged in the misconduct").

[31] *See* Act, § 105(c)(4)(D)(i) (certain monetary sanctions), (E) (censure), (F) (professional education or training) & (G) (any other sanction provided for by the PCAOB's rules).

3502, on its face, seems to apply to all sanctions authorized under Section 105(c)(4) and all violations of the applicable securities laws, related rules and regulations, or standards.[32]

Even assuming the PCAOB may have the power to adopt an appropriately circumscribed negligence standard, as a matter of policy it should not exercise that power. The proposed rule would have the consequence of making lawbreakers out of individuals caught by the "negligence" standard, because any violation of Rule 3502 would constitute a violation of the securities laws.[33] Individuals acting in good faith—indeed, with an intent to uphold all of the securities laws—who nonetheless might be deemed to have "negligently" "contributed" to a

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[32] *See also* Open Meeting Tr. at 34 ("this rule is not limited to anything about tax services . . . it's not limited to anything about independence . . . [i]t would be a general prohibition against causing an accounting firm to violate some provision of the law that the accounting firm was subject to, so it would sweep across our entire spectrum of rules").

It was suggested at the Open Meeting that the PCAOB could require a negligence standard to impose the lighter penalties under Section 105(c) of the Act. *See* Open Meeting Tr. at 37-38. However, Congress's silence with respect to the standard of intent required for these sanctions should not be read as an explicit grant of authority for the PCAOB to adopt a negligence standard. Moreover, the penalties at issue are not fairly viewed as "light" sanctions, especially since they must be reported to the Commission, State regulatory authorities, foreign accountancy licensing boards and the public, and include personal fines up to $100,000. Act, § 105(d).

Nor does the "failure to supervise" provision permit sanctions for mere negligence. To be sanctioned for "failure to supervise," an "associated person" must have had "reasonable cause to believe" that he had failed to comply with firm procedures and systems. *Id.* § 105(c)(6)(B). The "failure to supervise" provision also provides objective safe harbors to avoid liability.

[33] *See id.* § 3(b) ("A violation by any person of . . . any rule of the PCAOB shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq*.) or the rules and regulations issued thereunder, consistent with the provisions of this Act, and any such person shall be subject to the same penalties, and to the same extent, as for a violation of that Act or such rules or regulations.").

violation, whatever that might mean, would be subject to PCAOB enforcement. A negligence standard in these circumstances would be too harsh.[34]

The circumstances in which the application of the rule would be unduly harsh are virtually unlimited in light of the number of individuals who would be subject to the new rule and the complexity of the laws, rules, and standards that ultimately would give rise to potential violations. The proposed rule would apply to all "person[s] associated with a registered public accounting firm," which for a single registered firm could be thousands of individuals.[35] The rule could be implicated by any one of these individuals engaging in behavior that they neither intended, nor reasonably believed, would "contribute" to the firm violating any of the following complex set of laws and regulations: (1) the Act; (2) the Rules of the Board; (3) "the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act"; or (4) professional standards. Such a complex and intricate rule regime is ill-suited to enforcement under a "negligence" standard.[36]

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[34] *Cf. Howard v. SEC*, 376 F.3d 1136, 1143 (D.C. Cir. 2004) (explaining that one who is unaware of any wrongdoing, even if such awareness is due to negligence, can not be held liable for aiding and abetting a securities violation); *In re IKON Office Solutions*, 131 F. Supp. 2d 680, 692 (E.D. Pa. 2001) (noting that "negligence, whether gross, grave or inexcusable, cannot serve as a substitute for scienter" in a securities fraud action) (internal quotes and citations omitted).

[35] Release at A-4-Rule.

[36] The difficulty of interpreting professional standards, for example, is reflected within the Release itself, where the PCAOB strongly suggests that the AICPA—a long-established,

[Footnote continued on next page]

We are concerned that the severe consequences of a negligence standard could be amplified by the proposed rule's additional provision, discussed in more detail below, that an individual's liability is premised on conduct contributing to his or her firm's violation of laws, rules, or standards. Thus, individuals would have to anticipate any "contribution" that their negligent behavior might make to conduct of their firm. Such a broad standard plainly is unworkable. Indeed, the Supreme Court has cautioned against the use of lower standards of intent in circumstances such as this, where sanctions can be imposed as the result of a violation of a complex set of laws.[37]

For all of these reasons, we recommend that the PCAOB not attempt to include the low threshold of a negligence standard in any final rule that it adopts. This can be accomplished by deleting the phrase "or should have known" from the final rule.[38] The standard of intent that would remain—"due to an act or omission the person *knew*"—is more appropriate and more workable, and is consistent with the Act's other provisions.

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well-staffed professional association—"may have been misinterpreting the SEC's contingent fee rule." Release at 9.

Moreover, given the complexity of compliance with the sometimes contradictory nature of professional standards around the globe and the registration of numerous foreign firms, there is a greater risk that individuals will inadvertently contribute to a firm violation.

[37] *See*, *e.g.*, *United States v. United States Gypsum Co.*, 438 U.S. 422, 444 (1978) ("[i]n dealing with the kinds of business decisions upon which the antitrust laws focus, the concepts of recklessness and negligence have no place"). Both tax law and professional standards are similarly complex, and we recommend that the PCAOB craft its rule accordingly. *See Nordlinger v. Hahn*, 505 U.S. 1, 11 (1992) (noting complexity of tax laws); Release at 9, 34 ("tax laws may often be complex and subject to differing good faith interpretations").

[38] Release at A-4-Rule.

"Contribute" Standard. As discussed above, we also are concerned that individuals can be held liable for behavior that they "knew or should have known *would contribute*" to a registered firm's violation of the securities laws, related rules and regulations, or professional standards.[39] It would be troubling enough for individuals to be subject to discipline for negligently *causing* a direct violation of the securities laws and regulations. Proposed Rule 3502 creates an even broader standard, however. An individual would merely need to negligently "contribute" to a firm's violation of the securities laws, rules and regulations, or professional standards to be sanctioned by the PCAOB.

The "contribute" standard has no clear meaning. Courts have assigned no general meaning to the term, and its dictionary definition—"[t]o give or supply in common with others"—similarly provides no guidance as to how it would function as a standard of liability.[40] There is thus a genuine risk that Proposed Rule 3502 would be applied overbroadly to sanction individuals inappropriately. One additional consequence is that firms would undertake excessive and unnecessary procedures in the face of uncertainty over the application of the rule.

Indeed, the "contribute" standard is subject to no express limiting principle. To the contrary, all other components of Proposed Rule 3502 suggest a broad application. As the proposed rule is currently drafted, an individual could "contribute" to a firm's violation of the law through mere negligence. Furthermore, an individual may not even need to engage in any

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[39] *Id.*

[40] WEBSTER'S II NEW COLLEGE DICTIONARY 245 (Houghton Mifflin 2001); *see also*, *e.g.*, *id.* ("[t]o act as a determining factor").

conduct to "contribute" to a firm's violation—an instance of non-action could be sufficient. The broad application of Proposed Rule 3502 suggested by the Release is further compounded by the breadth and complexity of the laws and rules at issue, the numerous individuals who would be covered by Proposed Rule 3502, and the obligation of individuals to predict how their current conduct, or for that matter inaction, may later "contribute" to a violation of those complex laws and rules by their firm.[41]

We encourage the PCAOB to address these concerns in any final rule. Considering the potential ramifications of this standard for individuals, we recommend that the PCAOB delete "contribute" from its final rule and substitute "cause."

B. Proposed Rule 3520: Auditor Independence

We support the PCAOB's goal of promoting auditor ethics and independence—principles of vital importance to issuers and investors, as well as to the accounting profession itself—in Proposed Rule 3520.[42] Moreover, we recognize that Title II of the Act authorizes the PCAOB to adopt ethics regulations.[43] In proposing Rule 3520, however, the Release asserts that the

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[41] *See* note 29 above. At a minimum, the PCAOB should require that, before a violation could be shown, the affiliated person must provide knowing aid to the firm violating the law or rule, with the intent to facilitate the violation.

[42] Proposed Rule 3520 provides: "A registered public accounting firm must be independent of its audit client throughout the audit and professional engagement period." Release at A-4-Rule.

[43] *Id.* at 12; Act, §§ 103(a), 201(a).

PCAOB is "not promulgating any new independence requirement."[44] As described below, we ask the PCAOB to clarify this point.

The Release seeks comments as to "ways in which the proposed scope of the rule would cause or require auditors to follow any different practices and procedures than they currently follow to comply with existing legal requirements."[45] Although Proposed Rule 3520 may not affect auditors' practices and procedures directly, the PCAOB's adoption of a new regulatory regime could potentially change practices and procedures. The Note to Proposed Rule 3520 acknowledges that any regulatory regime adopted by the PCAOB will co-exist with the Commission's existing regime.[46] Almost by definition, dual regulatory regimes cause confusion, thereby affecting issuer and auditor behavior.[47]

Because issuers and registered firms are already familiar with the Commission's regulations, we suggest that the rules endorse continued compliance with the Commission's existing regime whenever possible. Specifically, we encourage the PCAOB to refer to existing Commission regulations, definitions, and guidance. Reliance on the Commission's existing regime will lead to less confusion for auditors and audit committees, thereby reducing the

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[44] Release at 20.

[45] *Id.*

[46] *Id.* at 20, A-4-Rule.

[47] Similarly, the PCAOB asks: "Would the scope of the ethical obligation described above impose any practical difficulties?" *Id.* at 20. The existence of two distinct independence requirements—one in the Commission's regulations, and one in the PCAOB's rules—will pose significant "practical difficulties" if the two requirements are interpreted differently.

inevitable burdens and costs that accompany the adoption of new rules.[48] Although we realize that the PCAOB, in performing its duties, may choose to adopt more stringent regulations, we believe that the PCAOB would minimize the risk of confusion by stating clearly that, where its rules and guidance are silent with respect to a particular ethics or independence issue, or where the PCAOB imports Commission definitions or terms into its rules without modification, Commission standards continue to govern, particularly in situations where activities currently permitted by the Commission are not expressly addressed by the final rules. In addition, we recommend that the new rules explicitly identify any departures from the Commission's regulatory regime. We believe that this will facilitate Commission review and promote effective and efficient compliance with PCAOB rules.

C. Proposed Rule 3521: Contingent Fees

We accept the positions of the Commission's staff regarding the prohibition of contingent fee arrangements—as clarified in the Commission Chief Accountant's letter of May 21, 2004 ("Nicolaisen Letter"). We believe that these positions are now clear and should be given effect.[49] In adopting any final rule, we recommend that the PCAOB clarify how its

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[48] *Cf.* Paperwork Reduction Act of 1995 (Pub. L. No. 104-13, 109 Stat. 163), 44 U.S.C. §§ 3506(c)(1)(A)(iv), 3506(c)(2)(A)(ii) (requiring federal agencies engaging in rulemaking to provide estimates of burdens and costs that would result from proposed rules).

[49] Letter from Donald T. Nicolaisen, Chief Accountant, Office of the Chief Accountant, U.S. Securities and Exchange Commission, to Bruce P. Webb, Chair, Professional Ethics Executive Committee, American Institute of Certified Public Accountants (May 21, 2004), *available at* http://www.sec.gov/info/accountants/staffletters/webb052104.htm) (last visited Jan. 31, 2005).

independence rules with respect to contingent fees differ from those of the Commission and clarify what it means for a firm to "indirectly" receive a contingent fee from an audit client.

The Release states that the PCAOB intended to model Proposed Rule 3521 and the related definition of "contingent fee" on existing Commission independence rules.[50] However, the Release states that the PCAOB's standard "differ[s] from [the Commission's] rules in important respects."[51] The substantive effects of the two rules—*i.e.*, what is and is not a "contingent fee"— are similar, although, as noted in the Release, the PCAOB proposal would eliminate certain words that exist in the Commission's rule.[52] We encourage the PCAOB to confirm any deviation from the Commission's existing rule in the final Release to avoid any potential confusion in this matter.[53]

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[50] Release at 23.

[51] *Id.*

[52] The PCAOB's rule would "eliminate the exception in the text of the [Commission's] rule for fees 'in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies.'" *Id.* The Release identifies this as the "principal difference" between the two rules, and describes the PCAOB's motivation in removing this language from its rule as risk of misinterpretation, as described in the Nicolaisen Letter. *See id.*; Nicolaisen Letter at 2-3.

[53] In addition, the PCAOB has invited commenters to identify other courts or public authorities that "fix fees that are not dependent on a finding or result." Release at 23. However, we believe that the PCAOB's articulation of a general standard—"courts or other public authorities"—is superior to one that would attempt to identify in advance an exhaustive list of such possible decisional authorities. The creation of such a list could lead to confusion and ambiguity in the future, if courts or decisional authorities other than those enumerated in a final rule in fact were to "fix fees that are not dependent on a finding or result."

[Footnote continued on next page]

In addition, we recommend clarification regarding what it means for a firm to receive a contingent fee or commission from an audit client "indirectly."[54] We agree with the PCAOB's intent to "discourage efforts . . . to seek to avoid application of the rule through use of intermediaries." However, we suggest that the Board consider clarification on this point to avoid precluding a broader group of clearly permissible transactions by utilizing the term "indirectly."[55] We encourage the PCAOB to state that the ban on "directly or indirectly" receiving a contingent fee is directed solely at subterfuges or deliberate attempts to craft a disguised contingent fee.

D. Proposed Rule 3522: Tax Transactions

We concur with the PCAOB's goal of prohibiting tax services associated with certain "aggressive" tax motivated transactions and generally believe that the provisions of Proposed Rule 3522 advance that goal, as well as the goal of Congress to "draw a clear line around a limited list of non-audit services that accounting firms may not provide to public company audit

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[Footnote continued from previous page]

> We certainly believe, however, that arbitral panels and tribunals should be captured in any final rule. For example, such arbitral tribunals have many of the hallmarks of the judicial system, including a system of rules, an adversarial process, and independent decisionmakers. Given the Congressional endorsement of arbitration embodied in the Federal Arbitration Act, 9 U.S.C. §§ 1-16, there appears to be no reason why the PCAOB should refuse to recognize fees awarded by such independent bodies. If the PCAOB were concerned that arbitral bodies would not be included as "other public authorities" under the rule as drafted, it could amend the rule to reach "other public or private independent decisional authorities."

[54] Release at 24, A-5-Rule.

[55] *Id.* at 24.

clients."[56] With that in mind, our comments regarding Proposed Rule 3522 are largely focused on clarifying the scope of the proposed rule. Without such clarification, we are concerned that issuers, audit committees and audit firms could face unintended difficulty in complying with the final rule.

Before commenting specifically on the individual provisions of Proposed Rule 3522, we would like to comment on the importance of clarifying the overall scope of the rule. Proposed Rule 3522 provides, in general, that a registered accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any non-audit service to the audit client related to planning, or opining on the tax treatment of, a transaction – (a) that is a listed transaction; (b) that is a confidential transaction; or (c) that was initially recommended by the registered public accounting firm or another tax advisor and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowed under applicable tax laws.

By its terms, we believe that this provision will be effective in addressing a type of tax service cited by the Release as having "raised serious concerns"; that is, marketing of tax shelter products by audit firms to their audit clients.[57] We recommend, however, that the PCAOB clarify the types of traditional tax services that are still permitted—tax services that clearly do not involve the marketing of tax shelter products. The Release makes it clear that the PCAOB does not intend for its proposed rules to prohibit audit firms from providing traditional tax

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[56] S. Rep. No. 107-205, at 18 (2002); *see also* 67 Fed. Reg. at 76783.

[57] Release at 8.

services.[58] It then identifies "tax services that the Board has considered and determined not to prohibit" because the services have not raised independence concerns.[59] Those services include "routine tax return preparation and tax compliance," "general tax planning and advice," "international assignment tax services," and "employee personal tax services."[60] We encourage the PCAOB to confirm that permissible services are not limited to the specific tax activities mentioned in the Release, but include all traditional tax services not expressly prohibited in the Release. To that end, we recommend that, in addition to the current descriptions of permissible services included in the Release, the PCAOB adopt the description of traditional tax services contained in the Commission's discussion of tax services under the rubric of "tax fees":

> [I]t would include fees for tax compliance, tax planning, and tax advice. Tax compliance generally involves preparation of original and amended returns, claims for refund and tax payment-planning services. Tax planning and advice encompass a diverse range of services, including assistance with tax audits and appeals, tax advice related to mergers and acquisitions, employee benefit plans and requests for rulings or technical advice from taxing authorities.[61]

We also believe it is important to provide in any final rule that an auditor retains the ability to perform functions as auditor, even if that entails commenting on prohibited

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[58] *Id.* at 14-16.

[59] *Id.*

[60] *Id.* at 14-17.

[61] 68 Fed. Reg. at 6031.

transactions.[62] The interests of investors are best protected when transactions are transparent to the auditor; accordingly, an auditor must always be in a position to observe, review, and evaluate such transactions.

Finally, the PCAOB should consider a transition rule that explicitly permits audit firms to provide continuing tax services with respect to transactions initiated before the effective date of the final rule, or before a specific service is deemed to be prohibited.

1. 3522(a): Listed Transactions

We are generally encouraged by the proposed rules' reliance on standards fashioned by the Internal Revenue Service ("IRS").[63] Final rules that are tied to existing regulations will provide a much greater degree of clarity than rules that are newly developed and will help promote independence by facilitating compliance with the applicable standard.

For purposes of Proposed Rule 3522(a), a listed transaction is defined through reference to Treasury Regulation § 1.6011-4(b)(2); i.e., a transaction that is the same as or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction. The PCAOB should consider clarifying this definition such that it only applies to transactions undertaken by U.S. issuers attempting to achieve U.S. tax benefits. Without this

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[62] That appears to be the PCAOB's intent. *See*, *e.g.*, Release at 26 ("Proposed Rule 3522 is intended to describe a class of tax-motivated transactions that present an unacceptable risk of impairing an auditor's independence if the auditor participates in the transaction in any capacity *other than as auditor*.") (emphasis added).

[63] Release at 27-31.

clarification, transactions governed by the laws of a foreign jurisdiction could be considered "substantially similar" to a listed transaction under U.S. Treasury Regulations, thereby impairing independence, notwithstanding that the transaction and its tax consequences may be appropriate and acceptable—or even required—under the laws of the foreign jurisdiction. We believe that requiring issuers and auditors to apply U.S. Treasury Regulations to evaluate transactions undertaken in foreign countries and governed by foreign law is unnecessary. Rather, we believe that the three prong test set forth in Proposed Rule 3522(c) relating to aggressive tax transactions is sufficient to address transactions that may arise outside of the U.S.

The PCAOB asked in its Release whether Proposed Rule 3522 should be extended to address the possible impairment of an auditor's independence when the audit firm has performed services relating to non-listed transactions that subsequently become listed.[64] We do not believe that Proposed Rule 3522 should be revised to affect an auditor's independence retroactively. Rather, we believe that the PCAOB should expressly state that the subsequent listing of a transaction is not independence impairing based on past services.

Significantly, any final rule that permitted past conduct to be judged against future rules could be found to be unlawful. As the U.S. Supreme Court has recognized, "the presumption against retroactive legislation is deeply rooted in our jurisprudence, and embodies a legal doctrine centuries older than our Republic."[65] Because "[e]lementary considerations of fairness dictate that individuals should have an opportunity to know what the law is and to conform their

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[64] *Id.* at 29.

[65] *Landgraf v. USI Film Prods.*, 511 U.S. 244, 265 (1994).

conduct accordingly," the "principle that the legal effect of conduct should ordinarily be assessed under the law that existed when the conduct took place has timeless and universal appeal."[66] Here, where Congress has not given the PCAOB express statutory authority to promulgate a retroactive rule, we would encourage the PCAOB to refrain from using its general rulemaking authority in such a manner.[67] Indeed, courts already have held that certain provisions of the Act cannot be applied retroactively.[68]

We also note that a retroactive "listed transaction" rule is not necessary to ensure auditor independence, given the applicability of the three prong test for aggressive tax transactions articulated in Proposed Rule 3522(c). We therefore urge the PCAOB not to extend the rule and to acknowledge explicitly that a tax transaction that is not listed when it is reviewed or presented by an audit firm will not later be deemed to have impaired the auditor's independence should the transaction become listed.[69] To the extent that the PCAOB has reservations with such a bright-line rule, it could adopt alternative measures that would not suffer from the fairness concerns or

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[66] *Id.* (quotation omitted).

[67] *See Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 213 (1988) (holding that an agency could not rely on its general rulemaking power to support a retroactive rule because the "statutory provisions establishing the [agency's] general rulemaking power contain no express authorization of retroactive rulemaking").

[68] *See*, *e.g.*, *Aetna Life Ins. Co. v. Enterprise Mortgage Acceptance Co.*, 391 F.3d 401, 411 (2d Cir. 2004) (provision of the Act extending statute of limitations for private securities fraud cases to longer of two years from date of occurrence or five years from date of discovery, did not revive investors' expired securities fraud claims).

[69] Finding independence impairments for services in connection with subsequently listed transactions also would sacrifice the benefits of clarity and certainty provided in the proposed rule.

retroactivity. For example, when a transaction becomes "listed" after the fact, the PCAOB could require that an auditor report the listing to the audit committee—as, indeed, the Release contemplates.[70]

Just as an auditor's independence should not be adjudged by future listing changes, neither should an auditor's independence be affected by past listings that are no longer in force. Thus, if a particular transaction is "delisted" by the IRS, a firm should be permitted prospectively to advise its audit clients regarding that transaction without jeopardizing its independence. Because the proposed rule does not specifically address this scenario, we encourage the PCAOB to clarify in the final rule that providing advice with respect to delisted transactions is permissible.[71]

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[70] *See* Release at 28-29. This is one area in which a transition rule will need to be in effect prospectively: for example, if an auditor provides a permitted service in 2007 that is thereafter prohibited, the auditor should not be deemed to have violated independence. Moreover, the auditor should be free to explain advice in any IRS administrative review. *See* 68 Fed. Reg. at 6016 ("independence will not be deemed to be impaired if an accountant explains the positions taken or conclusions reached during the performance of any service provided by the accountant for the audit client").

[71] The text of the proposed rule—"that is a listed transaction within the meaning of 26 C.F.R. § 1.6011-4(b)(2)"—could be read as permitting services in connection with any transaction that, at the time the service is offered, "is not a listed transaction." However, issuers and audit committees will benefit from clarity about how to approach "delisted" transactions.

2. 3522(b): Confidential Transactions

We also support the PCAOB's proposal to adopt the IRS's existing definitions with respect to "confidential transactions."[72] As in the case of the "listed transactions" provision, adopting the IRS's standards will facilitate compliance with the final rule.

Also as in the case of the "listed transactions" provision, we encourage the PCAOB to clarify that this rule only applies when the *audit firm* seeks confidentiality with respect to the U.S. tax treatment of a transaction. Without this clarification, significant uncertainty could arise when attempting to overlay U.S. Treasury Regulation concepts of confidentiality with the laws of a foreign jurisdiction.

The Board also asks whether any other provisions of the Treasury regulations regarding reportable transactions—that is, other than the provisions on listed and confidential transactions—should be incorporated by reference in the Board's rules on tax-oriented transactions that impair independence.[73] Our response to that question is no. The remaining categories of reportable transactions (e.g., transactions with contractual protection, certain loss transactions exceeding a threshold, certain book-tax differences exceeding a threshold, and transactions involving a brief asset holding period) merely represent triggers for disclosure. It is well recognized that these triggers can and do apply to numerous transactions where the tax treatment is not in question. Accordingly, we believe that applying such triggers to gauge

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[72] Proposed Rule 3522(b) defines "confidential transactions" with reference to Treas. Reg. § 1.6011-4(b)(3).

[73] Release at 31.

auditor independence would be ineffective and unnecessary, particularly given audit committee oversight of the performance of services involving confidential transactions.

3. 3522(c): Aggressive Tax Positions

Proposed Rule 3522(c) would treat a firm as not independent if the firm, or any affiliate of the firm, provides planning services for, or opines on the tax treatment of, a transaction that: (1) was initially recommended by the registered public accounting firm "or another tax advisor," (2) had as a significant purpose the avoidance of taxes, and (3) "is not at least more likely than not to be allowable under applicable tax laws."[74] While we agree with the PCAOB's use of such a three prong test for identifying those transactions that might raise questions regarding an auditor's independence, we have several concerns regarding the scope of this provision and a number of clarifying suggestions regarding its application.

The title of Proposed Rule 3522 is "Tax Transactions" and throughout the rule, references are made to "transactions." However, the heading under section (c) of the proposed rule refers to "Aggressive Tax *Positions*," notwithstanding that the text of that section is to be read in the context of a "transaction." We find the reference to "position" rather than "transaction" to be confusing, and fear that this lack of clarity could lead to uncertainty regarding the scope of the rule. Changing "positions" to "transactions" in provision (c)'s heading would result in consistency with the IRS regulations, the title and text of Section 3522 and the headings of provisions 3522(a) and (b). This would eliminate confusion as to whether the term "tax position" somehow alters or expands the scope of Rule 3522(c) beyond "transactions" that are

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[74] Release at 31, A-5-Rule.

the focus of Rule 3522, and facilitate the application of this rule by audit committees. Accordingly, we recommend that the PCAOB clarify Proposed Rule 3522(c) to use the heading "Aggressive Tax *Transactions*."

We also believe that it is important for the PCAOB to clarify the scope of the phrase transaction that was "initially recommended by the registered public accounting firm" as referenced in Proposed Rule 3522(c). For example, given the focus of the rule on prohibiting the marketing of tax shelters by audit firms, we believe that the phrase transaction that was "initially recommended by the registered public accounting firm" should be interpreted to refer to forward looking advice regarding the undertaking or implementation of a transaction by the client. In other words, where a client has already acted and the audit firm is merely giving advice (or preparing a tax return) as to the tax consequences of the client's actions, the transaction is not "initially recommended" by the audit firm and the rule should not be applicable. A typical example would be an audit firm giving advice as to whether certain client expenditures constitute qualified research expenses. Such advice would not involve a transaction that was "initially recommended by the registered public accounting firm" and should not be subject to the rule since the client's transaction (i.e., the expenditure) has already occurred and is not undertaken as a result of the audit firm's recommendation or advice.[75]

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[75] General tax planning of this nature is arguably excluded from the scope of Proposed Rule 3522 by reason of the "significant purpose of tax avoidance" test set forth in Proposed Rule 3522(c) (provided that the advice does not relate to a listed transaction and is not provided under conditions of confidentiality). However, without further clarification, the determination of whether tax planning rises to the level of a "significant purpose of tax avoidance" will be a continuing source of debate and confusion.

We also note that the proposed rule could prevent an audit firm from providing services in connection with an "aggressive" tax transaction to an audit client, even when the transaction giving rise to the tax service was initially recommended by a third-party tax advisor. We believe that the final rules prohibiting certain tax services should *not* apply when a tax advisor unrelated to the audit firm has brought the transaction in question to the issuer. When an audit firm is merely advising on transactions that the issuer chose to consider or undertake before the audit firm's involvement, the "mutuality of interest" that comes from the active promotion or "marketing" of tax-motivated transactions is decidedly lacking.[76] It cannot be said that such a situation presents "an unacceptable risk of impairing an auditor's independence" that justifies taking the matter out of the normal pre-approval regime.[77] Accordingly, we believe that the audit committee should retain authority and discretion in such matters.

However, there does appear to be one scenario where a transaction recommended by another tax advisor presumptively might give rise to independence concerns, and that is where the other tax advisor is acting at the behest of the audit firm and the two share an economic relationship. If the PCAOB is concerned about these types of arrangements, we suggest that it adopt an effective, yet much narrower provision, by changing the first sentence to: "that was initially recommended by the registered public accounting firm, either directly *or by another tax advisor acting at its suggestion* and a significant purpose of which . . . ." We also note that pursuant to Proposed Rule 3524(a)(ii), any compensation arrangement or other agreement, such

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[76] Release at 26-28.

[77] *Id.* at 26.

as a referral agreement, referral fee or fee-sharing agreement, between the audit firm and another tax advisor would be fully disclosed to the issuer's audit committee as part of the pre-approval process.

We fear that the broad scope of the first criterion will unnecessarily prohibit many services that do not bear on the auditor's independence, especially in light of the evidentiary standard that the Release requires in order to show that the transaction was initiated by "another tax advisor." The Release cautions that auditors may not simply rely on representations by the audit client that the transaction was client-initiated "if reasonable, good faith diligence by the auditor" would have revealed otherwise.[78] Because we believe that the PCAOB should altogether eliminate from the scope of the rule those transactions initiated by other tax advisors, here we simply highlight that the "good faith diligence" standard is ambiguous.

In addition to addressing concerns about the first criteria of Proposed Rule 3522(c), we recommend that the PCAOB also consider clarification of other aspects of the provision. For example, the final rule should make clear that an audit firm would not violate the rule by "opining" on an aggressive tax transaction (one with a significant purpose of tax avoidance and more likely than not to be not allowable), if the audit firm advises the client that a transaction recommended by another tax advisor would *not* meet the "more likely than not" standard. Issuers often look to their audit firm to provide sound advice as to the tax treatment of transactions initiated by the issuer or a third party advisor. In those circumstances, it is clearly in the issuer's and the investing public's best interest that the audit firm be free to provide candid

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[78] *Id.* at 32.

and timely advice regarding the transaction without jeopardizing independence, notwithstanding that such advice may be that the contemplated tax treatment of the transactions does *not* meet the "more likely than not" standard. Indeed, the PCAOB's chief auditor has specifically expressed this view, stating that "[t]he rule is not intended to prevent an auditor from advising a client not to do a transaction. What's contemplated in the term planning or planning on a transaction is planning that transaction to fruition or providing a positive opinion on that transaction."[79] Similarly, situations arise in which, in the normal course of advising an issuer, an audit firm brings a possible transaction to the attention of an issuer, but ultimately does not recommend the transaction based on an analysis of the particular facts and circumstances or other due diligence. The PCAOB should clarify the proposed rules to provide that when an audit firm investigates a transaction on behalf of a client, but ultimately *does not recommend* execution of the transaction, or as described above, provides an opinion that specifically states that the transactions does *not* meet the "more likely than not" standard, the auditors' independence is not impaired. We see no benefit in deterring the audit firm from evaluating and advising a client that a transaction does not work. Rather, we believe that it is the investing public's best interest not to limit the audit firm's ability to provide candid and timely advice regarding a transaction.

Clarification is also necessary in the context of mergers and acquisitions ("M&A"). We believe, and the PCAOB apparently agrees, that an audit firm should not be precluded from "assisting [issuer] management in determining how to properly and accurately structure [an

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[79] *See* PCAOB, Open Meeting Tr. at 31 (Dec. 14, 2004) (statement of PCAOB Chief Auditor, Douglas R. Carmichael).

M&A] transaction under all applicable tax laws."[80] Most M&A transactions are entirely motivated by business considerations, but the choice of acquisition structure might be motivated, in significant part, by tax considerations. To that end, we recommend that the PCAOB clarify that the criterion of "significant purpose of tax avoidance" is evaluated in the context of the entire business transaction, rather than by simple comparison to other, less tax efficient structures. Moreover, we believe that clarification is needed in this context as to what constitutes a "client initiated" (and thereby permissible) transaction under the rule. For example, we believe that when a client requests tax advice relating to a proposed M&A transaction, that transaction is clearly client initiated and any tax advice provided in response to that request should not be subject to the aggressive tax transaction rule.

It would also be helpful if the proposal was clarified such that it does not prevent registered public accounting firms from providing tax advice with respect to expenditures and events undertaken, or to be undertaken, by the audit client in the ordinary course of its business without regard to the tax consequences thereof (e.g., advising an issuer as to the potential application of the recently enacted IRC Section 199 Manufacturing Deduction).

Finally, the PCAOB asks whether registered firms should be required to "obtain a third-party tax opinion in support of the tax treatment, if the potential effect of the treatment could have material effect on the audit client's financial statements."[81] We believe that the PCAOB

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[80] *See id.* at 25, 26 (statement of PCAOB Assistant Chief Auditor, Bella Rivshin).

[81] Release at 35.

should not mandate that registered firms obtain a third-party tax opinion. Rather, that decision should be left to the discretion of the audit committee.

E. Proposed Rule 3523: Tax Services For Senior Officers of Audit Client

We agree with the PCAOB's decision to narrowly tailor Proposed Rule 3523 to include only those tax services that a registered public accounting firm provides to individuals in a position to play a significant role in an audit client's financial reporting, specifically, officers in a "financial reporting oversight role." However, as described below, we request that the Board clarify the scope of this provision in an effort to eliminate confusion and unintended compliance issues.

Proposed Rule 3523 is to be read in conjunction with Proposed Rule 3501(f)(i), which defines the term "financial reporting oversight role" as:

> a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.[82]

Although the Board quotes the Commission's definition of financial reporting oversight role verbatim as that term applies for purposes of the Act's "cooling off" period, the Release suggests that the rule will not be interpreted identically, particularly as it applies to members of

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[82] *Id.* at A-3-Rule.

the issuer's board of directors.[83] Indeed, the Release creates some confusion concerning Proposed Rule 3523's application to directors. On the one hand, the Release states that the "directors whose only role at an issuer audit client is to serve on the board would not be covered by the rule."[84] On the other hand, the rule text definition of "financial reporting oversight role" includes "member[s] of the board of directors," without further limitation.[85]

Therefore, we recommend that the PCAOB clarify that the individuals covered by Proposed Rule 3523 are the same as those covered by the Commission's "cooling off" provision, with two modifications—excluding members of the issuer's board of directors and covering individuals only at the issuer level. Referring to existing rules would provide consistency and clarity, particularly since issuers and their audit firms have been subject to the "cooling off" provision since it was enacted in 2002 and thus, already understand the definition.

With regard to the exclusion of directors from the proposed rule, the PCAOB inquires whether "independence [would] be perceived to be impaired if [the auditor] offered tax services to members of an audit client's audit committee, or to other members of the audit client's board of directors."[86] We believe that the answer to that question is no. As an initial matter, members of the board of directors do not have the same type of "financial reporting oversight role" that

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[83] *Id.* at 36 & n.73 (citing Rule 2-01 of the Commission's Regulation S-X, 17 C.F.R. § 210.2-01(f)(3)(ii)).

[84] *Id.* at 36.

[85] *Id.* at A-3-Rule.

[86] *Id.* at 37.

officers have. Moreover, because directors often serve on boards for multiple companies, they may find it unnecessarily burdensome to secure personal tax services from a registered public accounting firm, or might be required to frequently change personal tax relationships as they take on new board responsibilities, which would provide a significant disincentive to board service without any corresponding benefit to audit quality. Finally, we believe that members of the public would not reasonably attribute the same independence concerns to tax services performed for members of the issuer's board of directors as they would to services performed for key members of an issuer's management acting in financial reporting oversight roles. Accordingly, we recommend that the text of the definitional provision in Proposed Rule 3501(f)(i) be revised to delete "a member of the board of directors or similar management or governing body."[87]

We also recommend that the rule be clarified to cover individuals only at the issuer level. As currently drafted, the proposed rule could extend not only to key management of the issuer, but also to local management of any of its "affiliates." This would include any entity controlled or significantly influenced by the issuer—including its subsidiaries—unless the entity is not material to the issuer.[88] For large multi-national companies and their auditors, the issue of determining the importance of a subsidiary—and the role that an employee serves there—before the accounting firm could provide personal income tax services to that subsidiary's employee appears to render the rule more broadly prohibitive than the PCAOB may have intended.

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[87] Alternatively, if the PCAOB wants to retain the definition in Proposed Rule 3501(f)(i) for other purposes, it could amend Proposed Rule 3523 to specifically exclude "members of the issuer's board of directors not otherwise in a financial reporting oversight role."

[88] Proposed Rule 3501(a)(iv); (a)(ii); Release at A-2-Rule.

Moreover, as the Release notes, accounting firms often provide income tax services to employees of multi-national companies who are stationed all over the world.[89] Although it is clear under the proposed rule that the firm may not provide personal income tax services for the issuer's CFO, it is unclear whether the prohibition would extend to the president or controller of a foreign operating division. An audit firm providing income tax services under an expatriate engagement to an employee on an international assignment may not be immediately aware of changes within that foreign office—such as promotions—that may alter the employee's eligibility. Therefore, we recommend that the PCAOB restrict the scope of the proposed rule to apply only to key management at the issuer level.[90]

We also request clarification as to the type of tax services that are prohibited for those in a financial reporting oversight role. Specifically, we request that the Proposed Rule 3523 be limited to tax services directly related to an officer's "individual federal and state income tax matters." Applying the rule more broadly could result in unintended auditor independence issues (e.g., where an audit firm provides tax services to a publicly traded partnership, real estate investment trust, or mutual fund in which the CEO of a client issuer holds an ownership interest).

Finally, we would encourage the Board to create specific transition rules for this proposal. For example, the rules should be clear as to their application to individuals who become subject to the restrictions during an engagement period (including, but not limited to,

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[89] Release at 16.

[90] Assuming the PCAOB wishes to reach those situations in which the issuer is a holding company and the significant financial reporting work occurs in top-tier subsidiaries, it could amend the proposed rule to so provide, without reaching all the way into every subsidiary.

through initial public offerings and mergers and acquisitions), or conversely, those who fall outside the scope of the rules during such period. If an employee who does not fall within the PCAOB's proposed definition is later promoted to a position where he or she has a financial reporting oversight role, how and when must personal tax services be curtailed? Similarly, the PCAOB should clarify certain nuances of the rule's effective date. For example, could an audit firm continue to plan quarterly individual income tax estimates in conjunction with a prior-year tax compliance engagement for a senior officer who, after the effective date, will be considered to have a financial reporting oversight role at the audit client? We also request that the rule provide an accountant the ability to respond to any questions concerning tax services provided to an individual prior to a status change that precludes that individual from receiving tax services, whether in the context of a personal tax audit (federal or state), or otherwise.

F. Proposed Rule 3524: Audit Committee Pre-approval of Tax Services

According to the Release, the purpose of Proposed Rule 3524 "is to provide audit committees a robust foundation of information upon which to determine whether to pre-approve proposed tax services."[91] To that end, we firmly agree with the PCAOB that it is critical that audit committees have the information necessary to make informed decisions concerning auditor independence. In fact, we believe that an active and engaging audit committee pre-approval process provides the single greatest level of protection for identifying and mitigating potential independence impairing activities. We also believe that the existing pre-approval regime under the Act, and the Commission's rules implementing the Act, are working well. Although the

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[91] Release at 40.

existing regime has been in place for only two years, experience demonstrates that the current requirement is accomplishing its goals. Accordingly, we request that the PCAOB consider whether significant modifications to the existing rules are necessary and incrementally beneficial to issuers and the investing public at this time.

Our primary comments relate to Proposed Rule 3524(a)(i), which requires audit firms to provide audit committees every engagement letter, amended engagement letter, or any other agreement, whether oral, written, or otherwise, between the firm and the audit client related to proposed services. We are concerned that this provision may produce the unintended result of inundating audit committees with documents that are not necessary to make informed decisions concerning auditor independence. In contrast, we believe that with minor clarification, provisions (b) and (c) of Proposed Rule 3524, which require documented discussions with the audit committee regarding the potential effects of the proposed services on the independence of the firm, will help promote and ensure auditor independence.

The Act does not specify the type or quantity of documentation to be produced by an audit firm seeking an audit committee's pre-approval.[92] That does not mean, of course, that an audit firm can obtain pre-approval without providing documentation. Rather, the firm must provide as much documentation as the audit committee deems necessary to its decision-making. Congress has instructed that "[t]he members of the audit committee shall vote consistent with the standards they determine to be appropriate in light of their fiduciary responsibilities and such

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[92] Act, § 202.

other considerations they deem to be relevant."[93] The Commission's rules implementing the Act recognized the vast discretion assigned by Congress to audit committees. The Commission's rules require that pre-approval "policies and procedures are detailed as to the particular service, the audit committee is informed of each service, and such policies and procedures do not include delegation of the audit committee's responsibilities to management."[94]

The Commission has stated that "[t]he determination of the appropriate level of detail for the pre-approval policies will differ depending upon the facts and the circumstances of the issuer."[95] Accordingly, the amount of documentation that an audit committee requires will vary from case-to-case depending on the complexity of the service, the degree to which the service might jeopardize the auditor's independence, the preexisting knowledge base or experience of the audit committee, and other factors.[96] Moreover, audit committees have a strong incentive to seek the proper amount of information, because they face the risk of liability for breach of their duties.

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[93] S. Rep. No. 107-205, at 19-20.

[94] 68 Fed. Reg. at 6022.

[95] Office of the Chief Accountant, United States Securities and Exchange Commission, *Application of the January 2003 Rules on Auditor Independence: Frequently Asked Question*s No. 24, *available at* http://www.sec.gov/info/accountants/ocafaqaudind 080703.htm (last visited Jan. 31, 2005).

[96] The Release effectively acknowledges the case- and fact-specific nature of pre-approval. Release at 38 n.78 ("The proposed rule should not be understood to limit the information or materials that an audit committee may request, or that a registered firm may decide to provide, in connection with the pre-approval of tax services.").

In contrast to the existing regime—under which audit committees may procure the documentation they deem necessary to perform their function—we believe that Proposed Rule 3524(a)(i) is overly broad, in that it compels auditors to provide audit committees every engagement letter, amended engagement letter, and "any other agreement," whether "oral, written, or otherwise."[97] The engagement letter requirement alone could mean that auditors in many cases would need to produce—and audit committees would need to review—hundreds or even thousands of pages of documents each year in connection with the pre-approval of even routine tax services.

We are concerned that requiring audit firms to submit volumes of additional, often unnecessary information may actually hinder an audit committee's consideration of the most substantive aspects of an engagement. The potentially vast quantity of information could cause audit committees to give insufficient consideration to an audit firm's proposed tax service during the pre-approval process or simply encourage the rejection of all tax services proposed by the audit firm. Neither is required by the Act or by Commission standards, nor is either result in the best interest of maintaining audit quality.[98]

Further, as a matter of accepted practice, engagement letters may not be drafted or issued until after pre-approval has been sought and granted. Thus, provision (a)(i) would require audit firms to submit engagement letters describing tax services that, in many instances, already have

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[97] *Id.* at A-6-Rule.

[98] Permissible tax services provided by the auditor benefits both the audit and the transparency of tax reporting, and those benefits should not be sacrificed.

been detailed in one form or another to the audit committee during the pre-approval process. This could burden the audit firm and the audit committee while adding little, if any, value to the pre-approval process.

We also suggest clarifying the requirement that an audit firm document and produce "any other" written or oral agreement. This provision could be interpreted as requiring an audit firm to submit documentation to the audit committee concerning essentially every communication with the audit client. If this is indeed how the provision is interpreted, then it may be virtually impossible for an audit firm to comply fully with the rule. Similarly, provision (b) could conceivably require the audit firm to meet with the audit committee to discuss every minute agreement "relating to the service."[99] Such a system may be unduly burdensome and unworkable in practice.

Even if the PCAOB does not intend for the proposed rule to have the breadth described above, the proposed rule could be used against audit committees, issuers, and audit firms in litigation over whether the rule has been satisfied. As described, audit committees and audit firms could have difficulty proving that they discussed every communication, or "other agreement," and litigants might therefore have a ready-made claim for a "breach" of the rule.

Apart from the compliance issues of the proposed rule, we are also concerned that the proposed rule may have unintended consequences for the functioning of audit committees. Individual service on audit committees has already become significantly more demanding, given

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[99] Release at A-6-Rule.

the increased time and risk associated with such service.[100] To the extent that the final rules unnecessarily increase those burdens and risks, many otherwise qualified individuals may choose not to serve on these committees.

We recommend that the PCAOB consider these potentially unintended consequences, and the uncertainty of incremental benefits to be achieved by further regulating the pre-approval process. Rather than burden audit committees with voluminous quantities of material that may do little to aid the substantive evaluation process, we believe that the needs of audit committees would be best served by a final rule that recognizes audit committees' discretion to determine for themselves the appropriate level of documentation necessary to make informed pre-approval decisions. To accomplish this, we recommend that the PCAOB consider eliminating provision (a)(i) from any final rule, and instead expressly state that its rule does not affect the Commission's pre-approval regime.

In contrast to provision (a)(i), we believe that provisions (b) and (c) of Proposed Rule 3524 will help to promote continued auditor independence, and to further this goal, we suggest the following clarifications as to the breadth of each. We recommend the PCAOB clarify the scope of discussions required by provision (b). We believe that audit committees should retain the discretion to tailor discussions to suit their particular governance needs. The Release expressly contemplates that audit committees may grant pre-approval "on an ad hoc basis or on

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[100] *See* Martin Lipton, William T. Allen, and Laura A. McIntosh, *Advising the Audit Committee Today*, CORPORATE GOVERNANCE ADVISOR, May/June 2003 (discussing the "daunting" task of serving on an audit committee).

the basis of policies and procedures."[101] Similarly, the Commission's final rules regarding auditor independence state that "the audit committee may pre-approve audit and non-audit services based on policies and procedures and that explicit approval and approval based on policies and procedures are equally acceptable."[102] To eliminate unnecessary confusion regarding the scope of discussions called for in Proposed Rule 3524(b), we suggest that the final rule explicitly acknowledge that audit firms should discuss with the audit committee the potential effects of the tax services on the independence of the firm "in such manner and at such times as the audit committee deems appropriate."[103]

Likewise, we agree with the PCAOB that provision (c), requiring that the audit firm "document the substance of its discussions with the audit committee," will also promote continuing auditor independence.[104] However, consistent with our comments above, we would ask the PCAOB to consider whether it is beneficial to impose specific forms or occasions for auditor documentation of audit committee discussions.

IV. Conclusion

We strongly support the PCAOB's efforts to further the goals of the Sarbanes-Oxley Act through rulemaking. Moreover, we share the Board's goals of ensuring auditor ethics and

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[101] Release at 38.

[102] 68 Fed. Reg. at 6022.

[103] We also note that any differences in the pre-approval standards applicable to tax vs. non-tax services may generate unnecessary confusion.

[104] Release at A-6-Rule.

independence and applaud the considered judgments embodied in the proposed rules. Although we ask the Board to consider clarification or revision of certain provisions of the proposed rules, we support the rules' core provisions prohibiting contingent fees and certain defined "aggressive" tax services, as well as the balanced approach to ensuring auditor independence.

We appreciate the Board's consideration of our suggestions and views set forth herein and look forward to working with the PCAOB to achieve greater clarity in any final rules.

If you have any questions, please contact Robert Kueppers at (203) 761-3579 or Roger Page at (202) 879-5360.

Very truly yours,

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