

SUSAN M. COLLINS, MAINE, CHAIRMAN

TED STEVENS, ALASKA
GEORGE V. VOINOVICH, OHIO
NORM COLEMAN, MINNESOTA
TOM COBURN, OKLAHOMA
LINCOLN CHAFEE, RHODE ISLAND
ROBERT F. BENNETT, UTAH
PETE DOMENICI, NEW MEXICO
JOHN WARNER, VIRGINIA

JOSEPH I. LIEBERMAN, CONNECTICUT
CARL LEVIN, MICHIGAN
DANIEL K. AKAKA, HAWAII
THOMAS R. CARPER, DELAWARE
MARK DAYTON, MINNESOTA
FRANK LAUTENBERG, NEW JERSEY
MARK PRYOR, ARKANSAS

MICHAEL D. BOPP, STAFF DIRECTOR AND CHIEF COUNSEL
JOYCE A. RECHTSCHAFFEN, MINORITY STAFF DIRECTOR AND COUNSEL

United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510-6250

February 24, 2005

The Honorable William McDonough
Chairman
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Filed electronically at comments@pcaobus.org

**RE: Comment on PCAOB Rulemaking Docket Matter No. 017,
Proposed Rules to Strengthen Auditor Independence and
Limit Inappropriate Tax Services**

Dear Mr. Chairman and Members of the Board:

This letter is written in strong support of proposed rules issued by the Public Company Accounting Oversight Board (PCAOB) to strengthen auditor independence and place appropriate limits on the tax services that a registered public accounting firm may provide to an audit client that is a publicly traded corporation.

Auditor independence is essential to public confidence in audited financial statements, but has long suffered from confusion over the requirements for independence and from indifferent enforcement. The proposed rules would revitalize this area by, first, codifying in plain language the fundamental principle that an auditor must maintain independence from an audit client throughout the audit period and related engagement. The proposed rules would also bar a registered public accounting firm from entering into a contingent fee arrangement with an audit client, from providing tax services to certain executives of the audit client, and from planning or opining on certain aggressive tax positions involving the audit client. They would also help clarify and enforce the statutory requirement in the Sarbanes-Oxley Act that registered public accounting firms obtain prior approval from the audit committee of a corporation's Board of Directors before performing any tax service for that corporation.

Together, the proposed rules provide a set of minimum standards that would help restore auditor independence, increase investor confidence in corporate financial statements, and rein in abusive practices within the U.S. tax shelter industry. In fact, the proposed rules would benefit from additional, strengthening provisions, as suggested below.

Evidence of Abusive Practices

The U.S. Senate Permanent Subcommittee on Investigations, on which I serve as Ranking Minority Member, has conducted investigations into a variety of issues related to tax shelters and offshore tax havens. One key Subcommittee inquiry over the past two years has examined the role played by professional firms, such as accounting firms, in the development, marketing, and implementation of potentially abusive and illegal tax shelters. As recognized in the PCAOB materials accompanying the proposed rules, the Subcommittee's investigation culminated in hearings on November 18 and 20, 2003, and a report issued by my staff detailing four case studies of abusive tax shelters known as the Bond Linked Investment Premium Structure (BLIPS), Offshore Portfolio Investment Strategy (OPIS), Foreign Leveraged Investment Program (FLIP), and S-Corporation Charitable Contribution Strategy (SC2), which had been developed and promoted by KPMG.¹ Since then, the full Subcommittee has issued a bipartisan report providing not only additional detail about the KPMG tax shelters, but also information about potentially abusive or illegal tax shelters known as the Contingent Deferred Swap (CDS) and the Bond and Options Sales Strategy (BOSS), which were promoted by Ernst & Young (E&Y) or PricewaterhouseCoopers (PwC).²

The full Subcommittee report found that all three of the accounting firms it examined, KPMG, E&Y, and PwC, had been major participants in the U.S. tax shelter industry and involved in the development, marketing, or implementation of aggressive tax products for multiple clients. The evidence collected by the Subcommittee demonstrates that, among other actions, one or more of the firms targeted audit clients or executives at their audit clients when marketing potentially abusive or illegal tax shelters; sold tax products that did not meet the more-likely-than-not standard established within the firm; utilized contingent fee arrangements for these tax services despite legal and professional restrictions on such fees; and, in some instances, established alliances with audit clients to promote or implement potentially abusive or illegal tax shelters. The evidence of these abusive practices, set forth in hearing testimony, documentation and two reports, provides ample support for the proposed rules as summarized below.

Promoting Abusive Tax Shelters to Audit Clients

The Subcommittee investigation provides ample evidence that KPMG, E&Y, and PwC were, at various times from 1997 to 2003, heavily involved in selling potentially abusive or illegal tax shelters to multiple clients. In addition, during that time period all three firms were subject to investigation by the IRS for their tax shelter activities and required to disclose relevant documentation and client lists. Two of the accounting firms, E&Y and PwC, eventually agreed

¹ U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals" before the Permanent Subcommittee on Investigations (Nov. 18 & 20, 2003)(hereinafter "PSI Hearings"); and "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals" (Minority Staff Report, S.Prt. 108-34, Nov. 18, 2003), reprinted in the hearing record at 145-274.

² See "The Role of Professional Firms in the U.S. Tax Shelter Industry," (hereinafter "PSI Report"), released by the Subcommittee on Feb. 8, 2005.

to pay millions of dollars to settle the IRS legal actions and committed to dismantling their tax shelter practices; the third investigation is ongoing, but KPMG has publicly acknowledged selling inappropriate tax products, has committed to dismantling its tax shelter practice, and testified that, "Today, KPMG does not present any aggressive tax strategies specifically designed to be sold to multiple clients, like FLIP, OPIS, BLIPS and SC2."³

Documentation uncovered during the course of the Subcommittee investigation disclosed that, among its sales efforts, KPMG repeatedly attempted to sell aggressive tax products to its audit clients and their officers and directors. This evidence includes instances in which KPMG mined its audit client data to develop a list of potential clients for a particular tax product;⁴ developed tax products that were designed and explicitly called for "fostering cross-selling among assurance and tax professionals";⁵ and carried out marketing initiatives that explicitly called upon KPMG tax professionals to contact their audit partner counterparts and work with them to identify appropriate clients and pitch KPMG tax products to those audit clients.⁶ Another KPMG document stated that "many, if not most, of our CaTS [a KPMG group that sold generic tax products to multiple clients] targets are officers/directors/shareholders of our assurance clients."⁷

A recent report prepared by the Government Accountability Office (GAO) at my request, analyzing tax shelter services provided by accounting firms to publicly traded companies or their officers or directors, shows that KPMG was not alone in targeting audit clients for tax shelter sales.⁸ Using data compiled by the IRS and Standard & Poor's related to 500 of the largest U.S. publicly traded companies in 2003, as identified in Fortune magazine, GAO found that for the five year period, 1998 to 2003, 207 corporations, or about 40%, had purchased tax shelter services from a third party, of which 114 had purchased them from an accounting firm, and 61 from the company's own auditor. The GAO report also found that 57 of the Fortune 500 companies saw one or more of their officers or directors purchase tax shelter services from a third party, of which 33 purchased them from an accounting firm, and 17 from their company's own auditor. Altogether, GAO estimated that 114 of the Fortune 500 companies and 4400 individuals in the IRS database had purchased tax shelter services from an accounting firm, resulting in possible tax revenue losses to the U.S. Treasury totaling about \$32 billion.

³ See KPMG testimony at PSI Hearings (11/18/03).

⁴ See, e.g., Presentation dated 7/17/00, "Targeting Parameters: Intellectual Property – Assurance and Tax," with attachment dated September 2000, entitled "Intellectual Property Services," at page 1 of the attachment, Bates XX 001567-94.

⁵ Presentation dated 3/6/00, "Post-Transaction Integration Service (PTIS) – Tax," by Stan Wiseberg and Michele Zinn of Washington, D.C., Bates XX 001597-1611.

⁶ See e.g. email dated 8/14/01, from Jeff Stein and Walter Duer to "KPMG LLP Partners, Managers and Staff," "Stratecon Middle Market Initiative," Bates KPMG 0050369.

⁷ "CaTS" stands for KPMG's Capital Transaction Services Group which was then in existence and charged with selling tax products to high net worth individuals.

⁸ See "Tax Shelters: Services Provided by External Auditors," Report No. GAO-05-171 (2/1/05).

When accounting firms use their audit partners to identify potential clients and target audit clients for tax shelter sales pitches, they not only take advantage of the auditor-client relationship, but also create a conflict of interest in those cases where they succeed in selling a tax shelter to an audit client. This conflict of interest arises when the accounting firm audits the client's financial statements and, as part of that audit, examines the client's tax return and its use of the tax shelter to reduce its tax liability and increase its income. In such situations, accounting firms, in effect, are auditing their own work and impairing their independence.

Selling Dubious Tax Products

In addition to establishing that accounting firms were major participants in the U.S. tax shelter industry, the Subcommittee investigation found disturbing evidence that, in some instances, the accounting firms it examined were knowingly selling dubious tax products to multiple clients, at times over the objection of one or more of their tax partners. Two examples illustrate the problem.

First is the case of BLIPS, a potentially abusive tax shelter developed by KPMG. The Subcommittee investigation determined that KPMG had used an elaborate procedure to develop BLIPS and try to reach a consensus within the firm on the substance and wording of the KPMG opinion letters to be provided to BLIPS clients supporting the validity of the tax shelter.⁹ The evidence showed that, during the BLIPS review and approval process, some KPMG tax experts repeatedly raised strong technical objections to BLIPS and recommended against issuing a more-likely-than-not opinion letter for the product. Senior KPMG personnel pressured these tax experts to "sign off" on the product's technical soundness, despite their concerns. One key KPMG tax expert finally capitulated, sending his superior an email stating in part: "I don't like this product and would prefer not to be associated with it. However, [with] the additional [factual] representations ... I can reluctantly live with a more-likely-than-not opinion being issued for the product." He and other KPMG tax experts remained unconvinced, however, that BLIPS could withstand IRS scrutiny and continued to recommend against issuing a favorable opinion letter. Several months later, the KPMG tax expert wrote to his superiors: "[B]efore engagement letters are signed and revenue is collected, I feel it is important to again note that I and several other [KPMG] partners remain skeptical that the tax results purportedly generated by a BLIPS transaction would actually be sustained by a court if challenged by the IRS."

During this prolonged dispute within the firm, a senior KPMG tax professional sent an email to eight colleagues urging the firm's tax leadership to approve a tax opinion letter concluding that it was more likely than not that BLIPS would be sustained by a court. This senior KPMG tax professional frankly acknowledged the technical problems and reputational risks associated with BLIPS, but recommended going ahead and selling the product to clients. He characterized the key "business decisions" as follows:

⁹ See PSI Report discussion of "BLIPS Development and Approval Process," at 16-24.

“(1) Have we drafted the opinion with the appropriate limiting bells and whistles . . . and (2) Are we being paid enough to offset the risks of potential litigation resulting from the transaction? ... My own recommendation is that we should be paid a lot of money here for our opinion since the transaction is clearly one that the IRS would view as falling squarely within the tax shelter orbit.”

KPMG began selling BLIPS in 1999, and within a year issued tax opinion letters to 186 clients, obtaining more than \$50 million in fees and making BLIPS one of the firm’s highest revenue-producing tax products. In 2000, the IRS designated BLIPS an illegal tax shelter and took enforcement action against taxpayers who used it. Several of these taxpayers have, in turn, sued KPMG for malpractice in recommending they use BLIPS.

A second example involves a potentially abusive tax shelter known as CDS, which was marketed by E&Y. The Subcommittee investigation found evidence that internal E&Y deliberations over selling CDS to clients were marked by dissension and dissatisfaction.¹⁰ In this case, a small group of E&Y tax partners had reviewed and approved CDS for sale to clients, and arranged for an outside law firm to provide a legal opinion concluding that, if challenged, CDS “should” be upheld in court.¹¹ E&Y did not, itself, issue a tax opinion in support of CDS. Documents obtained during the Subcommittee investigation indicate that at least two E&Y tax partners expressed significant misgivings about the product, suggesting that it might not meet even the lower standard of “more likely than not.” One tax partner objected to selling the tax product using an outside law firm’s tax opinion, when E&Y itself had not determined that the tax product complied with the law. About the same time, in September 1999, a potential client’s outside counsel wrote to the firm that the CDS transaction “appears to be a classic ‘sham’ tax shelter that would be successfully challenged on audit by the IRS.” The outside counsel outlined numerous serious problems with the tax product and the opinion supporting it. This evidence shows that E&Y clearly knew CDS had technical problems and could qualify as an abusive tax shelter. The firm nevertheless actively marketed CDS from 1999 until 2001, selling 70 CDS transactions involving 132 taxpayers in return for fees exceeding \$27 million. In 2002, the IRS designated CDS an illegal tax shelter.

Both KPMG and E&Y had determined that the firm would only sell tax products that met or exceeded the more-likely-than-not standard. But both firms sold tax products that did not meet this standard and were subsequently determined by the IRS to be abusive tax shelters. These two examples raise serious questions about how a firm determines when the more-likely-than-not standard is met and how internal dissent should be handled.

¹⁰ See PSI Report discussion of E&Y approval of CDS at 84-87.

¹¹ E&Y later characterized the approval process in place at the time as “ad hoc, decentralized, and informal,” and told the Subcommittee that it has since been revamped. PSI Report at 82.

Use of Prohibited Contingent Fees

Another disturbing practice uncovered by the Subcommittee investigation was that all three of the accounting firms it examined had charged clients contingent fees based upon the projected tax savings to be achieved by a particular tax product, despite statutory and professional restrictions on these fees established by the Securities and Exchange Commission (SEC), many states, and the American Institute of Certified Public Accountants (AICPA).¹²

In the case of BLIPS, for example, the Subcommittee found that KPMG had typically set its fee equal to 7% of the generated "tax loss" that a client could expect from the transaction and use to shelter other taxable income. In the case of CDS, the Subcommittee found that, while E&Y expressed its fee as a flat dollar amount in its engagement letters, apparently to avoid contingent fee issues, internal E&Y documents showed that this fee was actually calculated as 1.25% of the tax loss to be generated by the CDS transaction. In fact, a sample E&Y engagement letter gave the following guidance to E&Y personnel writing an engagement letter for a CDS transaction: "Our fee for providing the professional services referred to above will be \$[Insert amount at 1.25% of losses to be generated]"¹³ According to E&Y, this fee arrangement meant that, in a typical CDS \$20 million loss transaction, E&Y received \$250,000 in fees from its client. A third example involves the case of BOSS, in which the Subcommittee found that PwC had typically required its clients to make an out-of-pocket cash investment equal to 8.5% of the target income to be sheltered or tax loss to be achieved, about half of which was then used to pay fees to PwC and other professional firms implementing the transaction.

Some tax professionals at the accounting firms warned against using such contingent fees. Within KPMG, for example, a senior tax partner took the position that fees based on projected client tax savings were contingent fees prohibited by AICPA Rule 302.¹⁴ However, other KPMG tax professionals disagreed, complained about this interpretation, and pushed hard for the firm to set fees based on projected tax savings. One memorandum declared that the senior tax partner's interpretation of Rule 302 "threatens the value to KPMG of a number of product development efforts," "hampers our ability to price the solution on a value added basis," and will cost the firm millions of dollars.¹⁵ The memorandum also objected strongly to applying the contingent fee

¹² See, e.g., 17 C.F.R. § 210.2-01(c)(5) (SEC contingent fee prohibition: "An accountant is not independent if, any point during the audit and professional engagement period, the accountant provides any service or product to an audit client for a contingent fee."); AICPA Code of Professional Conduct, Rule 302 ("[A] contingent fee is a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service.").

¹³ See Sample Engagement Letter, Bates 2003EY011138 (emphasis in original).

¹⁴ Subcommittee interview of Lawrence DeLap (10/30/03); memorandum dated 7/14/98, from Gregg Ritchie to multiple KPMG tax professionals, "Rule 302 and Contingency Fees – CONFIDENTIAL," Bates KPMG 0026557-58.

¹⁵ Memorandum dated 7/14/98, from Gregg Ritchie to multiple KPMG tax professionals, "Rule 302 and Contingency Fees – CONFIDENTIAL," Bates KPMG 0026555-59.

prohibition to, not only the firm's audit clients, but also to any individual who "exerts significant influence over" an audit client, such as a company director or officer. The memorandum stated this expansive reading of the prohibition was problematic, because "many, if not most, of our CaTS targets are officers/directors/ shareholders of our assurance clients."¹⁶ The position of the objecting tax professionals prevailed over that of the senior tax partner.

In addition, the Subcommittee investigation found that, in some instances, contingent fees restrictions appeared to have been circumvented through disingenuous management of particular engagements. For example, a KPMG document related to OPIS clearly identified the states that prohibited contingent fees. Then, rather than prohibit OPIS transactions in those states or require an alternative fee structure, the memorandum directed KPMG tax professionals to make sure the OPIS engagement letter was signed, the engagement was managed, and the bulk of services was performed "in a jurisdiction that does not prohibit contingency fees."

Prohibited Alliances with Audit Clients

Still another abusive practice uncovered during the Subcommittee investigation involves the willingness of KPMG, at times, to enter into professional alliances with audit clients to market or implement abusive tax shelters, despite SEC and company prohibitions to the contrary.¹⁷ For example, Deutsche Bank, HVB, and Wachovia Bank are all audit clients of KPMG, yet at various times all three played roles in marketing or implementing KPMG tax shelters. Deutsche Bank and HVB provided literally billions of dollars in financing to scores of KPMG clients purchasing either OPIS or BLIPS products. Without this financing, KPMG would have been unable to implement these tax shelters for its clients. Evidence shows that Wachovia Bank, through First Union National Bank, had set up a formal internal procedure to evaluate specific tax shelter promoters and tax products for possible introduction to bank clients. In April 1999, the bank formally approved making client referrals to KPMG (as well as to PwC) and offering KPMG tax products to its clients.¹⁸ First Union eventually referred numerous clients to KPMG, and was paid a \$100,000 fee for each client who actually purchased a tax product from the accounting firm.

¹⁶ "CaTS" stands for KPMG's Capital Transaction Services Group which was then in existence and charged with selling tax products to high net worth individuals.

¹⁷ The SEC "Business Relationships" regulation states: "An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders." 17 C.F.R. § 210.2-01(c)(3).

¹⁸ First Union also provided referrals to strategy providers other than KPMG and PwC. According to a former First Union employee, the due diligence process was designed in part to centralize referrals of various strategies and strategy providers to banking clients. Multiple banking groups were providing referrals of various strategies and strategy providers designed by law firms and investment advisors. Subcommittee interview with former First Union employee (5/27/04).

At the time these activities occurred, KPMG Tax Services Manual stated: "Due to independence considerations, the firm does not enter into alliances with SEC audit clients."¹⁹ KPMG defined an "alliance" as "a business relationship between KPMG and an outside firm in which the parties intend to work together for more than a single transaction."²⁰ KPMG policy was that "[a]n oral business relationship that has the effect of creating an alliance should be treated as an alliance."²¹ Another provision in KPMG's Tax Services Manual stated: "The SEC considers independence to be impaired when the firm has a *direct or material indirect* business relationship with an SEC audit client."²²

Despite the SEC prohibition and the prohibitions in its own Tax Services Manual, KPMG worked with audit clients Deutsche Bank, HVB, and Wachovia, on multiple BLIPS, OPIS and FLIP transactions. KPMG tax professionals were clearly aware that doing business with audit clients raised auditor independence concerns.²³ KPMG apparently attempted to resolve the auditor independence issue by giving clients a choice of banks to use in the OPIS and BLIPS transactions, including at least one bank that was not a KPMG audit client.²⁴ It is unclear, however, whether individuals actually could choose what bank to use. It is also unclear how providing clients with a choice of banks alleviated KPMG's conflict of interest, since it still had a direct or material indirect business relationship with banks whose financial statements were certified by KPMG auditors. This evidence of a firm's blatant disregard for auditor independence rules demonstrates the need not only for new rules, but also for new enforcement efforts.

Analysis and Recommendations

The Subcommittee investigation provides ample support for the auditor independence rules proposed by the PCAOB. In fact, the accumulated evidence suggests that some of the rules should be further strengthened as indicated below.

¹⁹ KPMG Tax Services Manual, § 52.1.3 at 52-1.

²⁰ *Id.*, § 52.1.1 at 52-1.

²¹ Minutes dated 9/28/98, of KPMG "Assurance/Tax Professional Practice Meeting" in New York, "Summary of Conclusions and Action Steps," Bates XX 001369-74, at 1373.

²² *Id.*, § 52.5.2 at 52-6 (emphasis in original).

²³ See, e.g., memorandum dated 8/5/98, from Doug Ammerman to "PFP Partners," "OPIS and Other Innovative Strategies," Bates KPMG 0026141-43 ("Currently, the only institution participating in the transaction is a KPMG audit client As a result, DPP-Assurance feels there may be an independence problem associated with our participation in OPIS"); email dated 2/11/99, from Larry DeLap to multiple KPMG tax professionals, "RE: BLIPS," Bates KPMG 0037992 ("The opinion letter refers to transactions with Deutsche Bank. If the transactions will always involve Deutsche Bank, we could have an independence issue."); email dated 4/20/99, from Larry DeLap to multiple KPMG tax professionals, "BLIPS," Bates KPMG 0011737-38 (Deutsche Bank, a KPMG audit client, is conducting BLIPS transactions); email dated 11/30/01, from Councill Leak to Larry Manth, "FW: First Union Customer Services," Bates KPMG 0050842 (lengthy discussion of auditor independence concerns and First Union).

²⁴ See, e.g., email dated 4/20/99, from Larry DeLap to multiple KPMG tax professionals, "BLIPS," Bates KPMG 0011737-38 (discussing using Deutsche Bank, a KPMG audit client, in BLIPS transactions).

Auditor Independence Requirement. The public has traditionally relied on independent auditors to ensure that financial statement audits of publicly traded corporations are fair, accurate and trustworthy. It is a fundamental principle and ethical obligation that the auditor evaluating the accuracy and fairness of a corporation's financial statement be independent of the audit client throughout the audit and the professional engagement period. Proposed Rule 3520 sets out that principle in clear and unmistakable terms, and should be adopted. Proposed Rule 3501(a)(iii) provides easy-to understand, bright-line rules for determining the beginning and end of the audit and professional engagement period, and provides needed clarity. Proposed Rule 3501(a)(ii) and (iv) together make it clear that the auditor must be independent not only of its direct audit client, but also the audit client's affiliates. Proposed Rule 3502 takes the essential step of stating that not only accounting firms, but also persons associated with those firms, are obligated not to cause the firm to violate any applicable law or regulation.

While strongly supporting these proposed rules, I respectfully suggest that they should be further strengthened in two ways. First, although the PCAOB materials discussing Proposed Rule 3520 cite the importance of auditors maintaining their independence in fact and appearance, the proposed rule itself makes no mention of the need for auditors to avoid circumstances which create the appearance or perception that an auditor's independence is impaired. Unless the proposed rule requires auditors to maintain the appearance of independence as well as actual independence, it will establish a standard that is weaker than and inconsistent with the Statement on Auditing Standards No. 1 and the Supreme Court cases cited in the PCAOB materials.

Secondly, the PCAOB should consider whether proposed Rule 3520 should be further clarified and strengthened by adding a new subsection directing auditors to consider among other factors whether a contemplated action would lead to: (a) a conflict of interest between the accountant and audit client; (b) the accountant's auditing his or her own work; (c) the accountant's acting as a manager or employee of the audit client; or (d) the accountant's acting as an advocate of the audit client. As explained in the PCAOB materials, these "four overarching independence principles" have long guided analysis of auditor independence issues by the SEC, AICPA, and others. Yet there is currently no mention of these principles in the text of the proposed auditor independence rules, despite their proven usefulness in analyzing whether particular practices impair auditor independence. The PCAOB is respectfully urged to incorporate them into proposed Rule 3520.

Contingent Fee Prohibition. Proposed Rule 3521 would prohibit accounting firms from providing any service or product to an audit client "for a contingent fee or a commission," paid directly or indirectly. Proposed Rule 3501(c)(i) defines "contingent fee" as "any fee established for the sale of a product or ... service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service."

This prohibition on contingent fees is a necessary step to help eliminate improper incentives that create a conflict of interest between an accounting firm's conducting a

dispassionate analysis of a client's financial reporting and tax obligations, and adopting an aggressive interpretation to justify charging the client substantial fees based upon the client's alleged savings. Extending this prohibition to cover contingent fees paid "directly or indirectly" is an appropriate response to evidence in the Subcommittee investigation regarding the tactics used by some accounting firms to disguise the contingent nature of their tax shelter fees. The proposed rules' narrow exception to the prohibition is also appropriate in light of the wholesale misuse of the exception in the SEC and AICPA rules by some accounting firms seeking to justify the imposition of contingent fees. As written, the new contingent fee prohibition would provide a clear directive to registered public accounting firms to stop using these fees. To be effective, however, the new rule would have to be accompanied by rigorous enforcement.

Prohibition on Promoting Aggressive Tax Positions. Proposed Rule 3522 would prohibit registered public accounting firms from planning or opining for an audit client a transaction which qualifies as a "listed" or "confidential" transaction under IRS regulations, or which qualifies as an "aggressive tax position" under the proposed rule. The proposed rule defines an "aggressive tax position" as one which was "initially recommended" by the accounting firm or another tax advisor, and has "tax avoidance" as a "significant purpose," unless the proposed transaction "is at least more likely than not to be allowable under applicable tax laws."

In essence, the proposed rule seeks to prohibit registered public accounting firms from advocating aggressive tax positions to their audit clients. Recent history has made it clear that the lucrative fees that accounting firms can obtain from promoting aggressive tax positions undermines their independent judgement on the merits of such transactions and encourages abusive tax shelter practices by publicly traded corporations. The prohibition also establishes a useful framework focused on listed transactions, confidential transactions, and aggressive tax positions.

It is also important to note, however, that the proposed rule would impose essentially the same standards for tax products sold by accounting firms which the major accounting firms claim they have already been following for years, but which failed to prevent these firms from promoting abusive tax shelters. For example, all three major accounting firms examined by the Subcommittee claimed that they did not, as a matter of policy, promote listed transactions or confidential transactions as defined by the IRS regulations. They also claimed that each of the tax products examined by the Subcommittee had been analyzed and found by the firm to be more likely than not to survive a court challenge. The proposed rule does not lay down any tougher standards for these firms, nor does the proposed rule indicate how the PCAOB would ensure greater compliance by accounting firms with the more-likely-than-not standard. For example, the rule says nothing about how accounting firms should handle internal dissension, when some of its tax partners dispute the position of other tax partners that a particular tax product is more likely than not to be upheld by a court.

To enforce the proposed standard, the PCAOB would have to take on the duty of reviewing specific tax products being promoted by accounting firms and, in consultation with the IRS, determine whether these specific products meet the more-likely-than-not standard in the proposed rule. While such PCAOB determinations would dramatically strengthen accounting firm oversight in the tax field, they might also invite substantial litigation that could sap the resources of the Board.

Another, possibly more fruitful approach would be to elevate the standard for tax products promoted by registered public accounting firms to any publicly traded corporation, whether an audit client or not. This elevated standard could require registered public accounting firms to promote only those tax products which, if challenged, "should" be upheld in court. Such tax products are supposed to have a significantly greater probability of being upheld in court than the 51% probability under the more-likely-than-not standard. This higher standard would match the standard already applied to tax transactions that may be included in the financial statements of publicly traded corporations, and would force accounting firms to meet a higher standard than currently. It would also discourage registered public accounting firms from promoting and publicly traded corporations from using questionable tax products that fall close to the line of acceptable practice. To require accounting firms to meet this higher standard, Proposed Rule 3523 could be amended by striking "at least more likely than not" and inserting "should be found."

Moreover, whether or not the Board toughens the standard for tax products promoted by registered public accounting firms, the proposed rule needs to address the issue of how a firm handles dissension within its ranks over whether a tax product should be offered for sale to clients. Proposed Rule 3522 should be amended to address this issue, perhaps by requiring registered public accounting firms to develop written rules for approving new tax products or services for sale, including procedures for resolving differing views on whether a new tax product or service violates the proposed prohibition on aggressive tax positions.

Finally, the proposed rule could be strengthened by adding a new subsection prohibiting registered public accounting firms from engaging in aggressive sales efforts related to tax services, including prohibitions on mass marketing tax products or services to multiple clients, initiating cold calls or other telemarketing pitches to multiple clients, or targeting audit clients for sales efforts. The proposed rule could also prohibit registered public accounting firms from developing sales leads using information collected from clients or prospective clients for tax preparation purposes. As currently drafted, the proposed rule prohibits planning and opining on aggressive tax positions, but not marketing them to multiple clients.

Tax Services for Certain Officers of Audit Clients. Proposed Rule 3523 would prohibit accounting firms from providing "any tax service to an officer in a financial reporting oversight role at the audit client." Proposed Rule 3501(f) clarifies that the officers covered by this prohibition are persons who prepare or exercise influence over a company's financial statements. This proposed rule would help eliminate a conflict of interest that has affected the

auditing profession. The GAO report cited earlier shows that the provision of tax services by an auditor to a company's officers and directors is not widespread, but does take place. The Subcommittee's investigation of KPMG establishes that this firm explicitly targeted the officers and directors of its audit clients for tax shelter sales.

The serious conflict of interest problems that can arise from this situation also became apparent in a review conducted by the Subcommittee into the sale of a tax shelter by E&Y to several officers of an audit client, Sprint Corporation, a publicly traded corporation. The Subcommittee learned that, in early 2000, E&Y used a conference room in Sprint headquarters to present information to a number of Sprint executives about a tax product that would allegedly defer the payment of taxes on large gains from stock options previously awarded to the executives by Sprint. The Subcommittee learned that over half a dozen Sprint executives purchased this tax product from E&Y, including Sprint's chief executive officer (CEO) and chief operating officer. After several of the executives had exercised their stock options, the Sprint stock price began to fall, and the IRS began to investigate the tax product as a potentially abusive tax shelter, several executives, including the CEO, asked Sprint in late 2000 to rescind their stock options and return them to the condition they had been in prior to exercising the options. Sprint consulted with E&Y and the SEC over the impact that such a rescission would have on its financial statement, determined that a rescission would require the company to recognize a multi-million-dollar expense, and declined to rescind the stock options. During the course of these events, E&Y was required to advise both Sprint and its individual officers on their best course of action. Over the course of 2001 and 2002, relations between E&Y and Sprint's top two officers deteriorated, as the IRS pressed both individuals about the tax shelter. In 2003, Sprint asked both officers to leave the company; in 2004, Sprint dismissed E&Y as its auditor. In 2003, Sprint adopted a policy prohibiting its auditor from providing any professional services, including tax services, to its executive officers, officers in its finance division, and audit committee directors.

The experience of the auditor in the Sprint matter, together with the Subcommittee's findings on KPMG and GAO's broader data analysis, provide ample evidence of the need for the prohibition contained in proposed Rule 3523 to prevent conflicts of interest and preserve auditor independence. The PCAOB should also consider amending the proposed rule to apply not only to officers, but also independent directors who exercise influence over the preparation of a corporation's financial statements.

Audit Committee Pre-Approval of Certain Tax Services. Proposed Rule 3524 would require a registered public accounting firm to provide to a corporation's audit committee detailed information about the tax services it would like to provide to the corporation. The firm must provide a copy of the actual engagement letter relating to the tax service, and that letter must detail the "scope of the service," "the fee structure," "any amendment to the engagement letter," and "any other agreement (whether oral, written, or otherwise) between the firm and the audit client, relating to the service." The firm must also disclose to the audit committee "any compensation arrangement ... referral fee or fee-sharing arrangement" between the auditor and any third party "with respect to the promoting, marketing, or recommending of a transaction

covered by the service," so that the committee can evaluate the auditor's independence. The proposed rule would further require the firm to discuss the "potential effects of the services on the independence of the firm" and document that discussion.

The proposed rule provides an effective way to implement the requirement in the Sarbanes-Oxley Act that audit committees of a publicly traded corporation make informed decisions about the tax services being provided by the corporation's auditor.

The proposed rule could be further strengthened and clarified by amending subsection (b) to require a registered public accounting firm to provide the audit committee with an analysis showing that a proposed tax service would not impair the firm's independence. Specifically, the rule could be amended to require the accounting firm to discuss orally, and later document in writing under subsection (c), whether the proposed tax service would lead to: (a) a conflict of interest between the accountant and audit client; (b) the accountant's auditing his or her own work; (c) the accountant's acting as a manager or employee of the audit client; or (d) the accountant's acting as an advocate of the audit client. As pointed out earlier, these four criteria have been identified by experts as critical tests in evaluating whether particular practices impair auditor independence. The PCAOB materials indicate that the Board considered including these four tests in the proposed rules, but did not want to limit the discretion of the audit committee or encourage it to apply "a rigid, mechanical application" of any framework or principles when analyzing a proposed tax service. The approach suggested here, however, would not limit the audit committee's discretion or create a rigid framework, but would provide the committee with a useful analysis by its auditor.

Conclusion

The bipartisan report recently issued by the Permanent Subcommittee on Investigations acknowledges and supports the work being done by the PCAOB to restore public confidence in the auditing profession and the U.S. financial reporting system. As part of that report, the Subcommittee made the following bipartisan recommendation:

"The Public Company Accounting Oversight Board should strengthen and finalize proposed rules restricting certain accounting firms from providing aggressive tax services to their audit clients, charging companies a contingent fee for providing tax services, and using aggressive marketing efforts to promote generic tax products to potential clients."

Thank you for this opportunity to comment on the proposed rules.

Sincerely,



Carl Levin
Ranking Minority Member
Permanent Subcommittee on Investigations