Tax Profs Urged SEC to Take Tough Stance on Auditor Independence

The following letters were sent by two groups of tax law professors to the Securities and Exchange Commission Secretary Jonathan G. Katz on January 10, 2003, and January 15, 2003, respectively.

Dear Mr. Katz:

We, the undersigned professors of law, support the SEC's proposals under Sarbanes-Oxley Act 201 that would prohibit an auditor from undertaking various tax services for an audited firm that undercut the auditor's independence.

- We agree with the SEC's conclusions that tax services are not per se prohibited by the Act, but that there is also no categorical exemption for tax services. Thus, activities that come within the scope of the prohibitions listed by Rule 10A(g) do not cease to be prohibited merely because they are also tax related.
- We think that the SEC proposals correctly identify sound principles inherent in the Sarbanes-Oxley Act that prohibit an auditor from (1) auditing its own work, (2) undertaking management functions for the audited firm, (3) acting as an advocate for the firm, or (4) promoting the firm's stock price or financial interests. Those principles should guide the auditors themselves, the Public Company Accounting Oversight Board, and the audit committees of the audited firms as to what types of activities may not be undertaken by the auditor, even as to tax services.
- We also support bright-line rules prohibiting certain tax-related services that are especially likely to undercut auditor independence.

Background

The Sarbanes-Oxley Act of 2002 manifests congressional shock that the auditing CPAs were not being loyal to outside investors who rely on financial reports. The Enron accountants, for example, taught Enron (for a good fee) how to maneuver through the minefields laid down by FASB standards on "unrelated" partnerships, so that the Enron financial statements arguably complied with technical requirements while simultaneously providing utterly useless or misleading "information" to investors. Since the auditing accountants participated in setting up the partnerships, there is not even a great deal of confidence that there was technical compliance. The accountants, we found out, were trying to be both Consiglieri and cops with respect to the same Don.

Auditors are a linchpin of our market system. The financial reports that auditors certify are critical to our economy because they so profoundly influence the flow of precious capital. When financial statements mislead investors, capital goes to less meritorious activities (for instance, to Global Crossing or Enron) or is utterly wasted. Cheating financial statements, certified by auditors, make it difficult for legitimate, successful enterprises to raise capital by selling stock. When diversified investors do not have reliable information about the firm, they must underbid for stock of the firm to take account of risks that the stock is a "lemon," worth less than the available information suggests. When foreign or diversified investors cannot count on accurate financial reports about stocks, they flee the market. In every part of the globe, if diversified investors do not have legal protection and accurate information, the market for stock is anemic. Firms must then raise their capital from bank financing; and when banks lend, they want to control corporate decisions. Cheating financial reports may provide a short-term advantage to the company that cheats, but the cheating hurts the common good of all companies in the economy by raising the cost of equity capital or making it entirely unavailable.

The lesson from the market is that an auditor firm must be zealously loyal in protecting the interests of investors. The auditor must ultimately place investor protection above accommodating management goals. The interest of an auditor that thinks of itself as a friend of management in provision of non-audit services inherently conflicts with the auditor's responsibility to maintain the necessary skepticism and zeal to audit the company properly on behalf of investors. The audit firm must be loyal to the efficient market. An auditor owes no duty to the audited firm, except insofar as enhancing the reliability of all financial reports makes equity capital cheaper for all.

Cheating financial reports ultimately steal from individual investors who rely in good faith on a company's audited financial statements. The Sarbanes-Oxley Act was a response to the justifiable anger of investors at losses incurred when auditors failed to stop deception: It is imperative that the SEC's auditor independence rules ensure that audited statements will not betray investors' trust.

Sarbanes-Oxley Act, Section 201

A. The Prohibited List

The Sarbanes-Oxley Act responded to the shock of Enron and other scandals by taking a series of measured steps to strengthen the independence of the CPA from the audited reporting firms. Section 201 of the Act, for example, amended the Securities Exchange Act of 1934, section 10A(g), to list nine activities that the auditor is prohibited from doing for the audited firm, including internal bookkeeping, appraisals, actuarial reports, management, legal representation, and provision of expert opinions. The ninth category is any other service that the proposed Public Company Accounting Oversight Board determines, by regulation, to be impermissible.

The Role of Tax Services. Activities not specifically listed as prohibited may be undertaken by the auditing accountant only with the advance approval of the audit committee of the Board of Directors of the audited firm. Tax services are not specifically prohibited. Nonetheless, classifying a service as a tax service does not mean that the service is automatically permitted. The SEC proposal correctly states that the act provides no categorical exemption for tax services nor, indeed, for any other non-listed services.

Thus, if services are both tax related and on the prohibited list, the services are prohibited. Section 201 of the act provides that "any non-audit service, including tax services, that is not described in any of paragraphs (1) through (9) of subsection (g)" may be undertaken with approval of the firm's audit committee. In that text, the descriptive phrase "not described in any of [the] paragraphs . . . of subsection (g)" modifies "tax services" as well as the phrase "any non-audit services." Thus, a service within the scope of the prohibited list may not be undertaken, even with audit committee approval and even if it is a tax service.

The act provides for no categorical exemption for tax services because the provision of tax services can clearly threaten auditor independence. Tax services are readily available in the competitive market, so no firm need compromise its auditors to secure adequate tax service. The institutional framework of accounting is also changing very rapidly, with auditing accountants spinning off their non-audit consulting services and new competitors continually entering the market. If there is a thin market for any tax service today, we can rest assured that by tomorrow the unregulated free market will fill in the gap with efficiency and at a competitive price. In a competitive free market, there is nothing about tax services that deserves a categorical exemption, or indeed any extraordinary favoritism of any kind.

Proposed Rule 210.2-01(c)(4) would delete the categorical exemptions that the rules provided prior to passage of the Sarbanes-Oxley Act, but the rule should go further to state explicitly that activities do not cease to be prohibited activities simply because they are tax related. Thus, by way of illustration, the rule should state that the auditor cannot provide the following:

(i) bookkeeping or other services related to the accounting records of the audit client, even if they are tax bookkeeping or tax accounting records;

(iii) appraisal or valuation services for the audit client, even when the appraisals or valuations are to be used to substantiate a tax return position or to support a tax opinion;

(iv) actuarial services, even if the actuarial services support a tax deduction;

(vi) management functions, even if the management function is related to tax planning or compliance; and

(x) expert opinions for an audit client in connection with legal, administrative or regulatory proceedings, including tax proceedings.

The Sarbanes-Oxley Act did not put tax services on the prohibited list of Section 10A(g). The commission's proposal tries to rationalize some special status for tax services, saying that tax services are special "because there are detailed tax laws that must be consistently applied, but also because the Internal Revenue Service has discretion to audit any tax return." The Act, however, did not create a special exception for tax services; instead, it merely failed to put them on the prohibited list.

The proposal language, moreover, offers unconvincing reasons (the detailed nature of the work and the possibility of an IRS audit) to accord tax services any special status. Neither rationalization works. Many prohibited services have mandatory details. Actuarial science is detailed and also prohibited. Expert testimony is often both detailed and as scientific as financial economics allows, and also prohibited. Within tax planning services, there are many opportunities for the adviser to further the client's financial interests against the tax collector and many opportunities to advocate for the client. If the service is prohibited, the fact that it is a tax service is irrelevant, despite the fact that tax has detailed rules. As to IRS oversight of tax services, the IRS audits less than 1 percent of taxpayers overall and catches on audit only some trivial percentage of contestable issues. An IRS audit is an adversial situation in which the auditor firm is put on the side of the audited company, and the auditor who gives tax advice has opportunities to promote the financial interests of the audited firm. In summary, the SEC's unseemly reliance on such flimsy safeguards would create genuine risks for auditor independence.

The unconvincing reasons offered for favoring tax services are at odds with the text of Sections 10A(g) and (h), which simply indicate that tax services are not on the per se prohibited list. The commission should not give more weight to the failure to prohibit than is justified. The right answer, as suggested by the commission, is that the auditor should not be permitted to perform a tax service if either the appearance or reality of auditor independence is threatened. At a minimum, therefore, the language on "detailed tax laws that must be consistently applied" and "the Internal Revenue Service has discretion to audit any tax return" should be omitted from any explanation for the auditor independence rules.

B. The Principles of Independence

The commission proposals also appropriately identify principles of independence for the auditing accountant that are inherent in the Sarbanes-Oxley Act, as follows:

(1) the auditing accounting firm may not be put into a position in which it must audit its own work;

(2) the auditing accounting firm may not function as part of management or as an employee of the audited firm;

(3) the auditing accounting firm may not act as an advocate of an audited firm; and

(4) the auditing accounting firm may not promote the stock price or the financial interests of an audited firm.

We believe that these principles of independence have both a mandatory role and an ethical influence. These principles should guide the Public Company Accounting Oversight Board in determining what specific activities to prohibit under paragraph (9) of the specific list of prohibited activities. The principles encapsulate the theory underpinning the listed prohibitions, and the Oversight Board will develop better rules for specific cases by applying the principles consistently and firmly. The principles also stand behind and justify some bright-line rules that the SEC should adopt, as described below.

The principles of independence should also guide each firm's audit committee in its decision whether to approve an auditor's undertaking activities that are not specifically prohibited. To ensure that the audit committees understand this requirement, we believe that the SEC should provide explicit guidance to audit committees. The audit committee has a measure of independence from management and inside directors of the firm, but its members remain subject to conflicts of interest. As evidenced in the corporate scandals this past year, management executives have incentives to inflate stock value to ensure that their stock options can be exercised or sold for the best possible price. Existing shareholders also tend to prefer inflation of value, at least until they have a chance to dump their stock. Faced with these pressures, the audit committee may find it difficult to demand accurate financial information without being bolstered by clear and specific SEC rules. Accordingly, we recommend that Proposed Rule 210.2-01(c)(7) on non-audit services provide explicitly that the audit committee may not approve non-audit services, including tax services, unless it has ascertained that providing such services will not place the auditing accounting firm in a position of auditing its own work, functioning as a part of management or making managerial decisions, acting as an advocate of the audited firm, or promoting the stock price or the financial interests of the audited firm.

The commission's blanket statement in the release that "auditor independence is not impaired by an accountant providing traditional tax preparation services to an audit client or an affiliate" may confuse audit committees and auditors because of the ambiguity regarding services covered by the phrase "traditional tax preparation services." Many tax services that might fit within the phrase "traditional tax preparation services" might also be on the prohibited list or violate the fundamental principles of independence. We believe that the Oversight Board and audit committees of audited firms should consider the inherent potential for conflict that aggressive return positions represent under the four basic principles. Therefore, we urge that the commission include an explicit statement to this effect in its rule governing approval of tax services by audit committees.

We think that, in the long term, audit committees should expect that better practice will require them to get all tax services from some source other than the CPA firm that is auditing the company. Not all better practice is required by law. Perhaps the audit committee can devise protections for the interests of the outside investors that will mean that tax services do not undercut the faith of the market in certified statements. Sarbanes-Oxley does not prohibit an auditor from providing tax services per se, but it does not give such a practice a ringing endorsement either.

C. Bright-Line Rules

The commission proposals solicited comment on whether the rules under section 201 should prohibit any tax services under the commissioner's independence rules. We respond to urge that the final rules should indeed include a list of specific tax-related services that the SEC staff has determined violate the four principles of independence. Although the following list is not comprehensive, we believe that the items mentioned here are sufficiently important to require inclusion in any such list promulgated.

1. *Tax minimization advice.* Formulating tax strategies designed to minimize an audit firm's tax obligations should be prohibited notwithstanding their tax-related nature. As the accountants themselves recognize, the tax accountant giving advice to any business firm is "duty-bound to assist his client in arriving at the most favorable way of measuring income for tax purposes." The tax accountant is "graded at least in part on taxes — the taxes he saves for his client." (Cox, Conflicting Concepts of Income for Managerial and Federal Income Tax Purposes, 33 *Accounting Review* 242, 242 (1958); Cannon, Tax Pressures on Accounting Principles and Accounting Independence, 27 *Accounting Review* 419, 426 (1952).) In other words, when it comes to tax minimization, the service provider is always graded on the bottom line — how much tax has the provider's service saved the firm. That bottom line goal inherently conflicts with the auditor independence principle requiring that auditors not promote an audited firm's financial interests, as well as the principle that audit firms cannot audit their own work.

2. *Tax Shelters.* What has been said above for minimizing tax obligations is doubly true for pure tax-

driven transactions such as those that have been developed and promoted by accounting firms over the last few years. Devising tax shelters violates the keystone principles of auditor independence. By promoting a particular shelter, an auditing accountant would be advocating in favor of particular positions on tax returns and financial statements. Indeed, many of the shelters are promoted expressly because they combine a lower tax liability with a favorable financial statement position. Inevitably, the auditor would also be called on to audit its own work. We strongly urge that the final rules prohibit an auditor from promoting to audited firms tax shelter transactions that it has devised.

The rules need also to prohibit auditing firms from creating or selling tax shelters to corporations other than the audited firm. The tricks of the trade in tax shelters circulate quickly. Gimmicks are borrowed from one firm and transplanted into another. Tax shelters also morph: A technique that the IRS has already attacked may be altered just enough to avoid the literal words of the IRS attack. For these reasons, the final rules should clarify that an auditor's independence is also impaired when it audits a "recycled" or "turnkey" tax shelter transaction, if the audit firm has proposed or developed the same or similar transactions, whether marketed to audited firms or to non-audit clients. An audit firm that creates and develops such tax products and then audits firms that have used a similar product is essentially auditing its own work. It would be difficult for an audit firm to insist on an increased financial reserve for a tax strategy that is essentially equivalent to one that the firm has proposed to non-audit clients. We are concerned that if this line is left blurred, auditors will not adequately evaluate financial results of tax-driven transactions and will not properly review tax reserves in financial statements.

3. *Tax Opinions for Third Parties.* As noted in the commission's proposed rules, auditors currently provide tax opinions for the use of third parties who engage in business transactions with audited firms. These opinions are inevitably important in persuading the third parties that the promised tax consequences will flow from the transaction. This practice directly places the auditor in the position of advocating to third parties on behalf of the audited firm and actively promoting the audited firm's financial interests. We therefore strongly support a rule that prohibits auditors from providing such tax opinions to audited firms.

Concluding Comment

We appreciate the opportunity to comment on this important issue. The proposed rules represent a significant reform in the current rules governing auditor independence. We believe that the incorporation of these recommended changes in the final rules will deter auditors from entering into tax services for audited firms that compromise their ability to render a credible, independent evaluation of the audited firms' financial statements.

Sincerely and respectfully submitted,

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We have circulated a draft of these comments to a number of academic colleagues, inviting them to endorse the comments or to submit comments of their own to the commission. We list below the names and affiliations (for identification purposes only) of those who have authorized us to include their names and to indicate that they agree generally with the substance and tone of this letter. Because time did not permit consideration of each individual's suggestions, they are not responsible for our language or the details of each comment or recommendation.

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