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IDW

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

United States

Düsseldorf, February 9, 2005
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Dear Sirs,

PCAOB Rulemaking Docket No. 017 "Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees"

The IDW, the professional organization representing public auditors in Germany, appreciates the opportunity to comment on the aforementioned Rulemaking Docket. We are pleased to see that tax services in general continue to be permissible. We also fully support the proposed ban on contingent fee arrangements in Rule 3521, because such arrangements significantly threaten auditor independence. Our comments focus mainly on three issues and can briefly be summarized as follows:

- Rule 3522: We suggest that the Board clarify certain aspects related to the application of the proposed ban on an auditor involvement in so-called listed and confidential transactions. Furthermore the Board should consider certain amendments to the criteria of an "aggressive tax position".
- Rule 3523: The notion of a "financial reporting oversight role" (although this term has been defined in Rule 3501), together with the rationale underlying the ban on any kind of tax services to senior officers are not sufficiently clear. Further clarification by the Board is crucial; at any rate we would have strong reservations if the rule were intended to be interpreted as extending this ban to services provided to non-executive management.
- Rule 3524: We oppose the considerable extension of the pre-approval requirements for permissible tax services, as proposed. There does not appear to be any justified reason to treat these services differently from other permissible non-audit services. Also, the IDW fears that if the proposed modified pre-approval procedures were to be implemented, audit committees would become

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very reluctant to engage the auditor to provide even permissible tax services (effect of a de facto prohibition). A de facto prohibition, however, is not only inconsistent with the Board's view that tax services apart from those explicitly banned usually do not raise independence concerns but would also impair audit quality.

Services Related to Tax Shelter Transactions

General Remarks

Proposed Rule 3522 intends to prevent the statutory auditor's involvement in abusive or potentially abusive tax transactions. Specifically, a statutory auditor may not engage in planning, or opining on the tax treatment of, (a) a listed transaction, (b) a confidential transaction or (c) an aggressive tax position. We understand that these kind of services can raise independence concerns which the Board seeks to address. However, we believe that certain clarifications as to the applicability of the Rule are needed. Furthermore, the Board should consider certain amendments to the criteria that define an aggressive tax position (Rule 3522 (c)) for the purpose of this PCAOB Rule.

We are aware that Rule 3522 is specifically tailored to accommodate the characteristics of the US tax system and in requesting the Board to take appropriate action in this regard, we have taken into account the fact that non-US auditors may face considerable difficulties when trying to apply this rule properly. For example, Germany has no "listing program" comparable to that of the IRS in the US, whereby all transactions characterized as potentially abusive are individually listed. Similarly, specific tax rules on so-called confidential transactions are unknown in Germany. As a consequence, when applying the PCAOB's rules, German auditors will have to look, in particular, to Rule 3522 (c), which we believe to be of a more general nature and to implicitly include listed and confidential transactions as specific subcategories of aggressive tax positions. In addition, these difficulties in applying the Board's proposed rules in an international context reveal the shortcomings of a rules-based approach that is aimed at accommodating the specifics of an individual jurisdiction. We believe that in this respect a framework concept, as underlying the IFAC Code of Ethic as well as the EU Recommendation on Auditor Independence, is clearly superior.

Applicability of Rules 3522 (a) and (b)

As stated above, listed and confidential transactions do not exist in Germany and probably in many other countries neither. Also, Rules 3522 (a) and (b) define listed

and confidential transactions by making reference to specific provisions of U.S. tax laws. Therefore, our understanding is that the applicability of Rules 3522 (a) and (b) is limited to transactions that are subject to U.S. tax jurisdiction. Nonetheless, we suggest that the Board explicitly confirm that view on the applicability of these Rules.

Furthermore, the Rulemaking Docket states, with regard to listed transactions, that once a transaction is actually listed, the listing act can impair the independence of an audit firm that formerly participated in the transaction, even if the firm's independence was intact at the time the transaction was executed because it reasonably and correctly concluded that the transaction was not the same, or substantially similar to, a listed transaction (refer to pages 28 and 29 of the Rulemaking Docket). That is, a subsequent listing shall also be able to affect the audit firm's independence. We believe that the Board should reconsider this treatment. Referring to future events introduces a degree of uncertainty that is neither acceptable for the audit firm nor the audit client. The parties must be able to finally assess both the current and the future impact of the service on auditor independence when determining whether or not the audit firm shall provide the service. Should the Board nonetheless maintain its present view, it must at least clarify that the listing act may only have a prospective effect on auditor independence. For example, if the listing act is concurrent with the audit firm's examination of the financial statements, the audit firm would not be considered as not independent with respect to that specific engagement, but only with respect to future audits (that is, there is no need to exchange the audit firm before termination of the engagement). Also, it remains unclear whether the Board's reasoning that a subsequent listing may impair auditor independence may also extend to other cases of future events. For example, the question arises if an auditor will be deemed no longer independent pursuant to Rule 3522 (c) after a transaction he formerly correctly judged to be more likely than not to be allowable later on turns out as impermissible under applicable tax laws.

In addition, we ask the Board to explicitly affirm that a tax-advisor-imposed condition of confidentiality, if taken on its own, does not necessarily cause the service to be qualified as prohibited under Rule 3522 (b). Conditions of confidentiality may be imposed for several reasons, a common one of which is avoidance of the tax advisor's liability to third parties. If this is the sole purpose of a confidentiality condition, we do not believe that a prohibition is warranted. Rather, it is primarily the combination of the confidentiality condition and the audit firm's intention to market the tax product to multiple clients that gives rise to a self-interest threat for the audit firm and, thus, for concerns about an impairment of the firm's independence.

Amendments to the Criteria of Rule 3522 (c)

In drafting Rule 3522 (c) the Board has identified three criteria that shall constitute an aggressive tax position. We strongly suggest that the Board consider redrafting the second criterion by replacing "*a significant* purpose of which is tax avoidance" with "*the sole business* purpose of which is tax avoidance". This is also the wording used in the Commission's guidance to the audit committee (refer to page 32 of the Rule-making Docket.

The Board should consider the fact that one of the main purposes of almost any tax advice – that is, not only of advice in connection with aggressive tax positions but of permitted general tax planning and advice as well – is to reveal to the client the potential for tax savings. Accordingly, the second criterion as currently proposed does not contribute sufficiently to providing an unambiguous distinction between allowable and prohibited tax services. In contrast, if the Board implements the amendment we have suggested, this criterion will more accurately reflect the nature of aggressive tax positions, since a unique feature of such positions is usually the absence of a significant business purpose apart from tax avoidance. In this respect, it will assist in providing a clearer distinction between "normal" (permissible) transactions and the abusive or potentially abusive strategies at which Rule 3522 is aimed.

The Board further introduces into Rule 3522 (c) the criterion that the tax service is prohibited only if the proposed tax treatment is more likely than not to be not allowable under applicable tax law. We suggest that the Board clarify that this likelihood is related to the advisor's expectation about the outcome of a final ruling by the tax courts, rather than the position he expects the IRS to take on the tax treatment (that is, whether or not the IRS is likely to challenge the transaction).

Another area of doubt associated with the more-likely-than-not-criterion in Rule 3522 (c) is whether the auditor shall be considered as not independent even in such circumstances where the outcome of his tax service is the advice that the audit client should abstain from the transaction because it is more likely than not to be not allowable under applicable tax laws. Indeed, to assume an impairment of auditor independence under such circumstances would seem extremely illogical to us. In principle, the same applies if the auditor's advice is confined to merely enumerate various alternatives, without, however, actively promoting those alternatives that will probably not be allowable. Consequently, we believe that a decisive criterion for applicability of Rule 3522 (c) should be that the auditor actively promotes a transaction that is more likely than not to be not allowable under applicable tax laws. In our view, the current term "initially recommended by the registered public accounting firm" conveys that idea only insufficiently. Moreover, we believe that this argument is particularly rele-

vant if it was not the auditor or an audit firm of the auditor's network that initially recommended the transaction but another tax advisor.

Finally, we suggest that the Board consider introducing into Rule 3522 (c) a kind of materiality exemption. Tax services are often provided on an ongoing basis involving numerous tax transactions, rather than on an item-by-item basis. Therefore, we believe that auditor independence should not be considered to be impaired if only one or a few of these transactions represent an aggressive tax position within the meaning of Rule 3523 (c) and these transactions are of minor importance. This proposal takes into a account that Rule 3522 (b) already includes a materiality exemption by referring to the minimum fee described in 26 C.F.R. § 6011.1-4(b)(3).

Tax Services for an Audit Client's Management

Proposed Rule 3523 precludes an audit firm from providing any kind of tax service to an officer in a financial reporting oversight role at the audit client. We have strong reservations about this rule, primarily because its justification remains vague (if existent at all) and it is not sufficiently clear which individuals will actually be affected. In particular, we question whether only members of the executive management are affected or whether the prohibition is also intended to extend to services provided to non-executive officers. The latter point is particularly important for the application of Rule 3523 outside the US in jurisdictions with different corporate governance structures, especially those with a two-tier corporate governance system.

To the best of our knowledge, the approach now taken by the PCAOB to preclude the auditor from providing tax services to an audit client's management is internationally unique. In the national and international discussions of which we are aware, provision of tax services to an audit client's management has never been identified as an issue that, per se, raises significant concerns about auditor independence. The PCAOB's Roundtable held last summer was the first juncture at which some participants indicated that the auditor should refrain from such services. However, even then proponents of a ban did not clearly indicate whether they fear an actual impairment of the auditor's factual independence or only feel a kind of investor specific "uneasiness" when the auditor provides tax services to management.

The Rulemaking Docket is not clear on this point either. It merely states on page 35 that the proposed rule would address concerns that performing tax services for certain individuals involved in the financial reporting processes of an issuer creates an appearance of a mutual interest between the auditor and these individuals. It is silent, however, on the concrete nature of such a mutual interest and how it could have the

potential to adversely affect the audit firm's independence and objectivity towards the financial statements to be audited.

We assume that the rationale underlying the mutual interest argument is that when an audit firm performs tax services for management, the relationship between management and the auditor might become too "cozy". Thus, when forming an opinion on the financial statements, the auditor could potentially be biased by this parallel relationship with management and thus potentially inclined not to uncover mistakes made by management in the preparation of financial statements. Should this understanding be correct, we suggest that the Board explicitly affirm it as the reasoning upon which Rule 3523 is based.

This additional explanation would also contribute to a clearer distinction of individuals to which the auditor may continue to provide tax services and those for whom performing all tax services will be prohibited, and, thus, to an adequate interpretation of the notion "financial reporting oversight role". Clarifying this matter is indispensable for the proper application of Rule 3523 in jurisdictions with corporate governance structures, which differ from those in the US. For example, under the German two-tier corporate governance system, which stipulates the distinct duties of the management board (executive board) and the supervisory board respectively, we believe that a financial reporting oversight role, as the term is applied in the Rulemaking Docket, rests solely with members of the executive board, and not with those of the supervisory board.

Under German law, preparation of the financial statements is the final responsibility of the management board. That is, financial statements exclusively contain assertions made by management. In contrast, the supervisory board has solely a monitoring function. It controls management, and in discharging its monitoring duties, the supervisory board is, inter alia, obligated to review the financial statements previously prepared by management to propose to the shareholders' meeting the auditor to be elected. Thus the supervisory board is not involved in the process of preparation of financial statements as such, and hence is not in the position to or does not exercise influence over the contents of the financial statements. Accordingly, we do not see that a client relationship between the audit firm and members of the supervisory board could create a mutual interest that has the potential to impair the auditor's objectivity towards the financial statements. Due to their monitoring function, members of the supervisory board have their own vital interest in an auditor exercising an objective and management-independent review. Consequently, our interpretation of Rule 3523 and the related definition of a financial reporting oversight role in Rule 3501 (f) (i) would be that an audit firm should not be prohibited from providing tax

services to members of a supervisory board or a similar oversight body that is not involved in the preparation of the financial statements.

Moreover, the Rulemaking Docket is silent on how Rule 3523 should be applied in the case of group structures. For example, the question could arise whether the auditor of a non-listed entity, which, however, is a subsidiary of a SEC registrant, is precluded from providing tax services to the executive management of that entity. We assume that this is not the case if the executive management of the subsidiary is in no way involved in the preparation of the (consolidated) financial statements of the SEC registrant. Nonetheless, a clarification that Rule 3523 does not prohibit the provision of tax services in such or similar circumstances would be helpful.

Pre-Approval Requirements for Permissible Tax Services

Proposed Rule 3524 is aimed at implementing the Sarbanes-Oxley Act's pre-approval requirements for allowable non-audit services by prescribing certain procedures that must be observed when audit committee pre-approval of permissible tax services is sought. Specifically, under the proposed rule an audit firm seeking pre-approval of such tax services would be required to

- provide the audit committee with detailed documentation of the nature and the scope of the proposed tax service;
- discuss with the audit committee the potential effects on the audit firm's independence that could result from the firm's performance of the service; and
- document the firm's discussion with the audit committee.

We understand that the prescription of such detailed pre-approval procedures is a direct response to the Commission's requirement for a *"detailed backup documentation that spells out the terms of each non-audit service to be provided by the auditor"* (refer to page 38 of the Rulemaking Docket). Nonetheless we are seriously concerned that the Board's approach is too bureaucratic, reduces flexibility below the level that is necessary given the variety of services concerned, and may impose disproportionate burdens not only on the audit firm but also, and in particular, on audit committees.

Rule 3524 does in fact also impose specific duties on audit committees, even though its sole direct addressee is the audit firm intending to perform certain tax services for an audit client. As a result, audit committees will be required – irrespective of the facts, circumstances and complexity of the individual case – to conduct an extended analysis of the information to be provided by the audit firm, discuss any potential independence issues resulting from the service with the auditor, form its own judgment

on the desirability of the service, and, in order to minimize the risk of claims for negligence, prepare its own documentation of the pre-approval procedures conducted and the conclusions reached. We fear that prescribing this degree of detail for the pre-approval procedure that must be undertaken will ultimately have a deterrent effect on audit committees. It will promote evasive action by audit committees to a significant degree, simply leading to the advance elimination of the audit firm from the range of potential providers of tax services. Consequently, even legally permissible tax services will indirectly become subject to a de facto prohibition as a result of excessively demanding pre-approval requirements. This is, however, inconsistent with the intention of the Sarbanes Oxley Act; in addition, we believe that it was not the Board's intention to pursue a de facto prohibition in proposing the new pre-approval requirements. We also believe that the involvement of the auditor in advising on the tax affairs of its client, within the bounds of what, under the proposed rules, is considered permissible, is a positive contribution to the quality of the audit because it gives the auditor a more detailed understanding of the client's tax position. Therefore, we strongly urge the Board to revisit Rule 3524 and give full consideration to the aforementioned unintended consequences.

Moreover, Rule 3524 does not take into account that permissible tax services may vary significantly by their nature and that it appears neither warranted nor practicable that each kind of service and each engagement must uniformly undergo the same demanding pre-approval process. This holds particularly true in case of SEC registrants that operate on a global basis with subsidiaries in many different countries. For example, it seems impossible, in terms of practicability, that each time a subsidiary faces a minor VAT issue of the jurisdiction where it is domiciled and on which auditor advice is sought to pass that issue through to the audit committee of the U.S. parent and to initiate a pre-approval procedure of the kind proposed by the Board. Also, the Board does not distinguish between ongoing tax services and those related to a specific project and occurring only occasionally. Whilst a detailed pre-approval procedure might be acceptable for project-related tax services of particular importance for the registrant or the group, this is certainly not the case for services provided on an ongoing basis and often involving the need for short-term reaction. In addition, it should be borne in mind that many tax services can be described only in a very general manner (for example, routine VAT return preparation for a certain subsidiary), leaving it open how the requirements of Rule 3524 can be satisfied in those cases.

Furthermore, we believe that regulatory action by the Board related to the pre-approval issue would be warranted only to the extent that past experience has revealed deficiencies of the pre-approval process in practice. However, we are not aware of any material weaknesses that would currently call for more detailed and rigid rules. In contrast, we understand that since its establishment the audit commit-

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tee pre-approval process has functioned satisfactorily and we believe that this is further attributable to the fact that the Commission's existing rules leave sufficient room for flexibility.

We hope that our comments are useful for the Board's further deliberations.

Yours truly,

Klaus-Peter Naumann
Chief Executive Officer