MILLER, HAMILTON, SNIDER & ODOM, L.L.C.
ATTORNEYS AND COUNSELLORS AT LAW

SUITE 305
ONE COMMERCE STREET
MONTGOMERY, ALABAMA 36104

POST OFFICE BOX 19
MONTGOMERY, ALABAMA 36101-0019

(334) 834-5550
TELECOPIER (334) 265-4533

PALMER C. HAMILTON
JOHN C. H. MILLER, JR.
RONALD A. SNIDER
GEORGE A. LEMAISTRE, JR.
LESTER M. BRIDGEMAN
CHRISTOPHER G. HUME, III
RICHARD A. WRIGHT
MATTHEW C. McDONALD
JOSEPH R. SULLIVAN
A. CARSON I. NICOLSON
JAMES REBARCHAK
GREGORY C. BUFFALOW
WILLARD H. HENSON
MICHAEL M. SHIPPER
KENNETH A. WATSON
ERIC J. DYAS
GILES G. PERKINS
BEN H. HARRIS, III
H. GARY PANNELL*
A. LEE MARTIN
MICHAEL E. RAY*

BEVERLY P. BAKER
GEORGIA S. ROBERSON
JAMES A. PATTON, JR.
HUGH C. NICKSON, III
W. KYLE MORRIS
DAVID F. WALKER
KAREN B. JOHNS
JON G. WAGGONER
KIRKLAND E. REID
WENDI M. BROWN
DAVID R. WELLS
H. WADE FAULKNER, JR.
ADAM M. MILAM
ROBERT L. CAROTHERS, JR.
BRIAN V. CASH
RYAN M. ADAY
T. SCOTT KELLY
MICHAEL A. WHITE
EDWARD B. HOLZWANGER
M. BRANDON MEADOWS
JAMES E. MURRILL, JR.

GEORGE A. LEMAISTRE, DECEASED
(1911 - 1994)

LEWIS G. ODOM, JR., RETIRED

OF COUNSEL:
BEVERLY P. HEAD, III

*NOT ADMITTED IN ALABAMA
ATTORNEYS ALSO ADMITTED IN ARKANSAS, DISTRICT OF COLUMBIA, FLORIDA, GEORGIA, ILLINOIS, LOUISIANA, NEW YORK AND VIRGINIA

February 14, 2005

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

Via e-mail to: **comments@pcaobus.org**

RE: Rulemaking Docket Matter No. 017

Dear Board Members:

I am pleased to be provided the opportunity to comment on PCAOB Rulemaking Docket Matter No. 017, "Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees." I believe that the vast majority of the proposed rules represent a significant step forward in securing the necessary independence of a public company's independent auditor. However, with respect to Rule 3523, it seems that the Public Company Accounting Oversight Board (the "Board" or "PCAOB") has confused the two important concepts of auditor selection (bias in favor of an auditor from the company's agents that select said auditor) and the auditor's pecuniary interests (bias in favor of a company from the auditor to protect a non-audit financial relationship). Rule 3523 currently states:

> **Rule 3523. Tax Services for Senior Officers of Audit Client.**
>
> A registered public 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 tax service to an officer in a financial reporting oversight role at the audit client.

The term "financial reporting oversight role" is very important to this rule and is currently defined as follows:

Rule 3501. Definitions of Terms Employed in Section 3, Part 5 of the Rules.

(f)(i) Financial Reporting Oversight Role

The term "financial reporting oversight role" means 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 or internal audit, director of financial reporting, treasurer, or any equivalent position.

At the outset, it is important to determine the stated purpose of these rules. The PCAOB release states that the "foremost [amongst the auditing profession's] ethical standards is the mandate that the auditor must be independent of his or her audit client. The independence requirement serves two related, but distinct, public policy goals. One goal is to foster high quality audits by minimizing the possibility that any external factors will influence an auditor's judgments... The other related goal is to promote investor confidence in the financial statements of public companies."

The PCAOB's release states that "Rule 3523 is narrowly tailored to include only those tax services that a registered public accounting firm provides to individuals in a position to play significant role in an audit client's financial reporting... directors whose only role at an issuer is to serve on the board would not be covered by the rule." If that is indeed the intent, then the definition should be revised to be exclusive rather than inclusive as it is currently worded. The plain meaning of the definition as currently drafted would include all the listed persons as well as any other person having a significant role in the audit client's financial reporting.

There are two means in which the independence of an auditor might be threatened or perceived to be threatened (and it is these two methods that the board has unnecessarily intermingled). The first is that there might be some tainting of the auditor selection process. The Sarbanes-Oxley Act of 2002 ("SOX") vested the sole authority to select a public company's independent auditor with the audit committee (Section 301of SOX). It is reasonable to assume that any other business relationship between the members of a public company's audit committee and the independent auditor might be viewed as tainting the selection process. Thus it would be reasonable to disallow an independent auditor's ability to provide tax or other accounting services to the members of an audit client's audit committee. As no other entity or person has the authority to select the independent auditor for a public company, the current drafting of Rule 3523 is

unnecessarily over-inclusive and unduly burdensome (from a compliance point of view) on accounting firms, public companies, their boards and executive officers.

The other way that the independence of an auditor may be threatened or perceived to be threatened is that the auditor may be asked to perform non-audit related services that are so financially advantageous to it, that it might be willing to adopt a more aggressive auditing position with respect to the preparation of a public company's financial statements than normal in order to satisfy the client. It is in this juxtaposition that the auditor's other relationships with the public company's executive officers that prepare the financial statements should be examined closely. However, it is unnecessary to assume that any non-audit relationship with an executive would taint the auditor's point of view. Relationships such as those reported in the situation where Sprint executives were said to have sold tax shelters by Sprint's independent auditor, and for which services, the auditor might have received as much as $5.7 million in fees, compared to the $2.5 million received by the auditor for the Sprint audit fees, are obviously egregious and could easily be perceived to taint the audit process for Sprint. However, for the PCAOB to use this situation as an example to justify Rule 3523 is clearly a case of "bad facts making bad law."

Relationships where the services sold to executives dwarf or are even a significant proportion of the total audit fees should clearly be the subject of scrutiny and should be deemed to impair an auditor's status as independent. However, the vast majority of accounting services provided to officers and directors are probably garden-variety tax return and estate planning services that would not result in fees that would be significant in comparison to the audit fees. In this situation, it is unreasonable, unnecessary and unduly burdensome (in terms of compliance) to completely forbid these relationships. Several means could be devised to prevent a public company's executives from entering into relationships with its independent auditor that would impair the auditor's actual or perceived independence while still allowing an executive to obtain immaterial tax compliance assistance. For example, (i) the public company could require that all such relationships be approved in advance by the company's audit committee, (ii) there could be a prohibition against tax shelters or similar non-conventional tax services to be provided to executives, (iii) or there could be some *de minimus* test. My preferred approach would be a combination of (i) and (iii).

While it cannot be denied that certain relationships with executives could taint or be perceived to taint the audit process, many, if not most, relationships are either benign or harmless. Rather than using a rule that places a comprehensive restriction on harmless activity and creates fairly serious compliance problems for both public companies and their auditors, it would seem preferable to craft an approach that would prevent relationships that might impair independence while still granting companies an appropriate amount of flexibility. It has already been pointed out that small companies

have different needs and different approaches than large companies. Likewise, many public companies and their executives will be seeking services from accounting firms that would in no way threaten the independence of such company's independent auditors. The most logical body to place the responsibility for determining if an auditor's relationship with an executive is inappropriate is the audit committee. Executives who seek out tax services with their company's independent auditor could be required to disclose this fact to the audit committee, along with a summary of the services to be provided and an estimate of the fees that the auditor will receive for such services.

As acknowledged in the PCAOB's release, "the SEC made clear that it did not consider conventional tax compliance and planning to be a threat to auditor independence, it distinguished such traditional services from the marketing of novel, tax-driven financial products." With respect to executive officers, the rules could state that:

> A registered public 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-conventional tax service or tax shelter to an officer in a financial reporting oversight role at the audit client.

However, this would not be my preferred approach as it is ambiguous and is subject to too much interpretation that could prevent the rule from functioning correctly in some circumstances.

A more definitive approach would be the adoption of a "*de minimus*" standard. This standard would state that if tax or other services provided to an executive were in excess of five percent of the estimated fees that the independent auditor would receive in a given audit year, then the provision of such services would invalidate the public accounting firm's independence as to that audit client for that audit year.

In conclusion, I would consider redrafting rules 3523 and definition (f)(i) as follows:

Rule 3523. Tax Services for Senior Officers of Audit Client.

(i) A registered public 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 tax service to a member of the audit client's audit committee; and

(ii) A registered public 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 tax service to an officer in a financial reporting oversight role at the audit client, unless (a) such tax service has been disclosed in appropriate detail, including the anticipated fees expected to be earned by the registered public accounting firm for such tax services, (b) the provision of such services has been approved by the public company's audit committee, and (c) such anticipated fees are no more than five percent of the fees that such registered public accounting firm will receive in connection with its audit of the public company's financial statements and internal controls.

(f)(i) Financial Reporting Oversight Role

The term "financial reporting oversight role" means 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, which may or may not include a person who is a member of the board of directors or similar management or governing body, the chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director or internal audit, director of financial reporting, treasurer, or any equivalent position.

By way of background, I am a corporate and securities attorney engaged in the representation of public companies. I have had an opportunity to work with many boards of directors and their committees, including their audit committees. I have seen firsthand how boards and their committees work, and I have seen their commitment to maximizing value while minimizing risk to their shareholders. Although I believe the views expressed in this letter would improve the PCAOB's proposed rules, they are solely my own and are not necessarily reflective of any other member of my firm or any client of my firm.

Once again, I appreciate being allowed the opportunity to comment on your proposed rules and appreciate the Board's consideration of my comments.

Very truly yours,

Hugh C. Nickson, III

cc: Bella Rivshin, Assistant Chief Auditor (rivshinb@pcaobus.org)
Greg Scates, Associate Chief Auditor (scatesg@pcaobus.org)