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December 22, 2004

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

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

Dear Board Members:

I am an attorney with no affiliation with any public accounting firm required to register with the Public Company Accounting Oversight Board (the “Board”). I commend the Board on its proposed rules relating to ethics, independence and tax services and offer several comments.

As a preliminary matter, I urge the Board to help restore investor confidence in the independence of auditors and the integrity of their audits of public companies by adopting a rule which prohibits the audit firm from providing tax services which are unrelated to the audit. For example, if an audit firm receives $5 million for tax services from its audit client concerning reorganization plans (mergers, acquisitions, divestitures) contemporaneously with performing an audit of the client’s financial statements for which it is paid $2 million, investors, creditors and other third parties who rely upon the financial statements may perceive that the audit firm lacks the objectivity and independence to challenge management’s financial statement assertions since to do so may affect the client’s retention of the auditors for similar tax services in the future. In other words, as a practical matter, the $5 million fee for tax services may distort the mental attitude, objectivity and independence required to perform the audit of the financial statements.

I believe the Board has clear and ample legal authority to prohibit such non-audit related tax services. I further believe the Board should exercise leadership in this area to persuade the SEC to the position that an audit firm should perform audits and not commingle that function with the performance of unrelated tax services.

Point I:

The Board Should Adopt a Rule that Restricts the Audit Firm to Performing Those Audit Services Necessary to the Audit and Not Allow it to Perform Other Unrelated Tax Services

Section 201(g) of the Sarbanes-Oxley Act ("Act") permits an audit firm to provide "tax services" to an audit client "if the activity is approved in advance by the audit committee of the issuer." The definition and scope of such permissible "tax services" is not set forth in the Act, but at first blush it would appear that "tax services", however defined, are acceptable. However, after listing eight other non-audit services in Section 201(g)(1) through (8) that are prohibited, Section 201(g)(9) grants the Board authority to prohibit "any other services that it determines, by regulation, is impermissible." Thus, as a legal matter, I believe that despite the Act's permitting "tax services" approved by the audit committee, the Board may, nonetheless, prohibit certain "tax services" from being provided by an audit firm to its audit client. The Board may prohibit certain of those tax services based upon its determination under Section 101 of the Act that it is necessary in order "to protect the interests of investors and further the public interest of informative, accurate and *independent* audit reports..."

The provision of "tax services" by audit firms in connection with the audit of the financial statements of its audit client has been limited until the recent past to examining management's calculation and allocation of tax liability, and auditing the income tax accounts to be reasonably assured they are fairly stated and accompanied by adequate disclosure. PCAOB Release 2004-015, December 14, 2004, at page 15. However, in more recent decades, other tax services unrelated to the audit have been performed by audit firms for their audit clients.

As to those other non-audit related "tax services," the SEC recently determined that it will not adopt a rule that prohibits them. It reasons that such non-audit related "tax services" should not be prohibited "partly because audit firms--both large and small--have historically played a part in return preparation and have advised their clients on the complexities of the tax code and how it affects the client's tax liabilities." PCAOB Release 2004-015, December 14, 2004, at page 7, citing SEC Release No. 33-8183, Section II.B.11, note 103 (January 28, 2003).

I do not believe that these "historical" practices and the SEC decision to permit such non-audit related tax services should be determinative of the Board's rule making in this area. Rather, if the Board believes an audit firm should perform audits and not other unrelated tax services (aside from those few tasks listed above which relate to the audit), it has ample authority to adopt such a rule under the aforementioned broadly stated statutory mandates. Moreover, it has been assigned a separate and specific role by the Act to address issues that affect audits and audit reports so as to restore public confidence in financial statements.

The fact that Board rules are subject to the prior approval of the SEC under Section 107 of the Act should not, *ipso facto,* deter the Board from taken a different position by deciding that unrelated "tax services" may (i) interfere with the audit firm's focus on the audit, (ii) distort its judgment, mental attitude and approach to the audit client, (iii) impair its ability to be truly impartial and objective since the firm may be reaping large fees from the same client for unrelated tax services, and (iv) affect the public's confidence in the audited financial statements as being the product of an audit (and only an audit) and not of unrelated tax services provided by the audit client. I use the word "may" because no empirical or scientific data can be brought to bear on this subject: it is a matter of how an audit firm behaves or may behave when in addition to the audit it is providing other unrelated "tax services" to a client.

In light of the foregoing, I urge the Board to step back and ask: *why should the audit firm provide any tax services to the audit client which are unrelated to the audit?* Surely, the client can obtain such services from a host of other tax advisors, including tax lawyers and other audit firms. To answer this basic question, the Board might look to the criteria used by the SEC. It has indicated that an audit firm should not have a relationship with the audit client or provide a service to it that (1) creates a *mutual interest* or conflicting one with the client; (2) puts the audit firm in the position of *auditing its own work*; (3) results in the audit firm acting in a management capacity; or (4) places the audit firm in the position of being an *advocate* for the client. See 17 C.F.R. Sec. 210.2-01, Preliminary Note, cited in PCAOB Release 2004-015 at page 4.

Does not the provision of tax services unrelated to the audit by the audit firm to its audit client conflict with and compromise several of those principles? First, by providing tax services such as tax planning for a reorganization transaction, is not the audit firm creating a "mutual interest" with the client in the tax services so provided? Do not both the client and the audit firm have the same or mutual objective of seeing that the tax plan is adopted and implemented?

In addition, do not such tax services inevitably place the audit firm "in the position of being an *advocate* for the audit client"? For example, is not the audit firm an advocate when its client is deliberating over whether to adopt a tax reorganization plan and implement it? Is it not, inevitably, an advocate of the client if the plan is challenged or opposed by others affected by it (e.g. stockholders, creditors, third parties) who may believe the plan is counter to the entity's best interests? And, will not the audit firm be an "advocate" of the client if the plan is challenged by the Internal Revenue Service, State tax authority or any other regulatory body?

And, finally, if the audit firm prepares the tax returns of an audit client is not the audit firm to some extent auditing its own work?

Since tax planning and other tax services unrelated to the audit are a significant part of the revenues and profits of the "Big 4" and many of the other audit firms subject to the Board's jurisdiction, any such prohibition will be resisted and unwelcomed. The Board, however, has demonstrated that it will not hesitate to adopt bold and far reaching rules when it deems it necessary to restore confidence in financial statements.[1] Thus, at this moment of time when it has the broad public support to act boldly I urge it to decide that audit firms are to do audits only and that the tax services they provide should be restricted to those few audit matters that call for measuring the adequacy of

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[1] To date, in other areas, the Board has taken a bold stance that differed from prior SEC positions: for example, in the standard concerning internal controls over financial reporting, the Board has required the outside auditor to perform an audit of such controls in conjunction with its audit of the financial statement; further, that the outside auditor report on the effectiveness of such controls. See "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements", PCAOB Release No. 2004-001, March 9, 2004, adopting Auditing Standard No. 2. Neither of these positions had been adopted by the SEC before the Board was created. In addition, the Board's rule was both far reaching and controversial in that it stretches the language and intent of Sections 103(a)(2)(A)(iii) and 404(b) of the Act. Thus, it can be argued that the Act does not require the outside auditor to either audit the internal controls or report on their effectiveness, but rather only to "attest to" and " report on" *management's*" assessment of the controls required by Section 404(a). However, in view of the public interest and the Board's mandate to restore public confidence in the reliability of financial statements, it adopted a more stringent and far reaching standard than had been the prior position of the SEC.

Similarly, the Board has adopted rules concerning audit documentation that go beyond the rules previously adopted by the SEC, including the rule that in multi-location audits the audit documentation supporting the work done by others be retained by or be accessible to the office issuing the auditor's report. See Audit Documentation and Amendment to Interim Auditing Standards, PCAOB Release No. 2004-006, June 9, 2004 at page 8, adopting Auditing Standard No. 3.

tax accruals and income tax liabilities. The Board should not allow the audit firm to provide other tax services that have nothing whatsoever to do with the audit.

New Legislation Needed to Separate Auditors from Non-Auditors

Along with this rule, I urge the Board to propose legislation to Congress that would require audit firms to separate themselves legally from other parts of their firm that perform tax services and other non-audit services. Thus, all auditors would be in one firm and all other personnel (tax advisors, management consultants, etc.) in another, with the management and profits of each firm separate. This will not only promote a greater degree of professionalism in the audit firm but also assist the Board in its regulatory responsibilities to inspect such firms.[2]

Point II: Proposed Rule 3522(c) re Aggressive Tax Positions Should Be Clarified

In the event the Board does not adopt the rule proposed in Point I, I urge it to clarify proposed rule 3522(c) which introduces the concept of a "tax advisor." The rule would consider the audit firm not to be independent if a significant purpose of the transaction, if recommended by the audit firm or a tax advisor, is tax avoidance and not likely to be allowed under tax laws.

The reference to a "tax advisor" sets up contradictory possibilities that may be confusing: for example, the tax advisor may propose a transaction it believes has many purposes but not a "significant" one of tax avoidance, while the audit firm may believe it has such a significant purpose. Does it matter what the tax advisor believes since the Board has no jurisdiction of such person or entity? Is not the rule focused on the audit firm's independence, and if so, does it matter who originated or recommended the transaction? A similar confusion arises if the tax advisor disagrees with the outside audit firm as to the probable allowance of the transaction under applicable tax laws? Does it matter what the tax advisor believes?

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[2] See the author's article: "Accountant Regulation One Year After Sarbanes-Oxley: Are More Reforms Needed?" BNA's Securities Regulation and Law Report, Vol. 36, No. 6, February 9, 2004, attached to this letter as a "PDF" document.

I urge the Board to delete all references to “another tax advisor” and simply provide that the audit firm will not be deemed independent if it engages in any tax planning for the audit client which has as a principal purpose tax avoidance and which the audit firm believes is not likely to be allowed under applicable tax laws.

Point III

Use Simpler Language Concerning Disallowance of a Tax Transaction

I urge the Board to use simpler language in proposed Rule 3522(c) in place of “not at least more likely than not to be allowed under applicable tax laws.” How about: “if the proposed tax treatment is more likely than not to be disallowed under applicable tax laws.”

Respectfully submitted,

Robert Chira

Analysis&Perspective

Accounting

Accountant Regulation One Year After Sarbanes-Oxley: Are More Reforms Needed?

BY ROBERT CHIRA

A general consensus exists amongst regulators and legislators that now is not the time to address the issue of whether additional reforms of public accounting firms are needed to prevent further audit failures. Instead, almost all interested parties agree that before further reforms are considered a careful assessment must be made of the impact on the firms of the Sarbanes-Oxley Act of 2002 (the "Act")[1] as well as the system of regulation by the Public Company Accounting Oversight Board ("PCAOB") it established.

It is also generally agreed that *professionalism* (as defined below) in the largest public accounting firms must be restored. The audit failures of the past few years demonstrate the need for such reparation. However, one leading commentator believes that while the Act and its new system of regulation correct many problems, the underlying malady, which afflicts the largest firms, is a lack of professionalism which cannot be so simply remedied. Instead, he asserts that they must change their leaders and internal culture, areas essentially outside the Act's purview and beyond the PCAOB's regulatory authority.

Professionalism embodies a variety of attributes, including: (i) independence by the outside auditor of the company's management in fact, attitude and mental approach to the audit; (ii) skepticism toward management's financial statement assertions; (iii) thoroughness of verification of management's proposed financial results; (iv) willingness to disagree with management's estimates, assumptions and judgments, even at the risk of impairing the relationship between the parties; (v) willingness to present more preferable and less aggressive accounting treatment of transactions to the audit committee or board of directors; (v) awareness that the outside auditor has been granted a franchise under the federal securities laws and is thus vested with a public trust;[2] and (vi) recognition that the auditor's certification and report constitute "the principal external check on the integrity of the financial statements."[3]

This article is written to stimulate discussion. It suggests additional reforms that should be considered by the PCAOB and Congress if future major audit failures continue to occur.

PCAOB's Initial Regulatory Efforts. The PCAOB had its first anniversary on January 6, 2004; it has achieved much under the substantial time pressures mandated by Congress. For example, in order to regulate accounting firms that audit public companies, the Act requires that they register with, and be inspected by, the PCAOB.[4] Approximately 740 firms have so registered. In addition, with a small start up inspection staff in 2003, the PCAOB conducted limited inspections of each of the "Big 4" audit firms. These firms audit almost 80% of the more than 15,000 U.S. public companies that file financial statements with the Securities and Exchange Commission (the "SEC").[5] In 2004, the PCAOB should reach a full cadre of several hundred inspectors and each year the Big 4 firms will be more rigorously inspected along with three other firms that audit more than 100 such companies. The remaining accounting firms, including more than 650 that audit fewer than five public companies, will also be inspected beginning then, but only once every three years.

In addition to registering and inspecting public accounting firms, the Act also gave the PCAOB authority to (i) conduct investigations and disciplinary proceedings of firms and their personnel; (ii) enforce compliance with the Act, PCAOB rules, securities laws pertain-

[1] Public Law 107-204, July 30, 2002.

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[2] "The independent public accountant . . . owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. . . ." *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-818 (1984).

[3] Report and Recommendations of the Panel on Audit Effectiveness, August 31, 2000, at p. 1.

[4] Section 102 of the Act titled "Mandatory Registration" makes it unlawful for any person that is not a registered public accounting firm to prepare or issue an audit report on a public company's financial statements.

[5] PricewaterhouseCoopers, Deloitte & Touche, Ernst & Young, and KPMG audit 97% of U.S. companies with sales of over $250 million, and approximately 78% of the more than 15,000 public companies filing financial statements with the SEC. See GAO Report, *infra* at pages 20-21.

ing to audit reports and "professional standards"[6]; and (iii) establish new standards in the areas of auditing, quality control, ethics, independence and, as a catch-all, "other" standards relating to audit reports.[7] Enforcement proceedings are likely to result from the inspection process and new rules have been proposed by the PCAOB to govern those proceedings.[8]

In addition, the PCAOB has begun to review existing auditing standards and make proposals to change them. Thus, it has proposed new standards requiring more extensive written documentation of the audit process that can be reviewed by outside, unrelated persons such as PCAOB inspectors. The retention in one central office of all such work papers has also been proposed so as to facilitate such inspections.[9] Also pending is a proposed audit standard for the outside auditor to attest to and report on management's assessment of the effectiveness of the entity's internal controls over financial reporting.[10] Expected to be proposed are changes to the current standards designed to detect fraud.

In an effort to achieve a greater degree of independence between the audit firm and its public company clients, the Act also prohibits eight specific non-audit services from being performed by registered public accounting firms for such clients.[11] All other services, including tax services, must be pre-approved by the company's audit committee or board of directors.

To address other areas of Congressional concern, the Act required that several significant studies be made, including one on consolidation and competition in the public accounting sector, the reasons for recent financial statement reporting violations and audit failures, and whether to require the mandatory rotation of accounting firms.[12]

In recent Congressional testimony, the Chairman of the PCAOB summed up the Board's work and specifically urged the accounting firms' leaders to work harder to restore public trust. He indicated that the passage of the Act and establishment of the PCAOB indicate that public accountants are being given a last chance to redeem themselves. He stated that if they did not meet this challenge, the PCAOB, using "tough love," would do whatever is necessary to restore professionalism. The Chairman further promised that PCAOB's inspections will examine the "tone at the top" of registered firms, including "the nature of the messages that are coming from the leadership of the firms and their frequency, and whether the messages are received and acted on." And, the PCAOB will look at how "behaviors are rewarded and reinforced through compensation and promotions" and the firm's "communication and training practices."[13]

Limitations of the Act's Regulation of Accounting Firms and Their Personnel. Although the PCAOB's statutory purpose is broad, that is "to oversee the audit of public companies . . . in order to protect the interests of investors" and to "further the public interest in the preparation of informative, accurate and independent audit reports,"[14] *its authority is, in fact, limited to only those parts of accounting firms and those personnel within them who audit public companies*. It may not be well understood but the PCAOB does *not* have any authority over other parts of a registered public accounting firm which perform audit and non-audit services for non-public companies. Nor does it regulate any firms that audit only non-public companies.

The former exclusion is significant when one examines the size of the seven largest public accounting firms which control more than 90% of the number of public companies that require the filing of audited financial statements. These firms have *professional staffs* of up to 20,000 persons and consist of partnerships of 200 to 2,600 partners.[15] Significantly, a substantial number of these professionals and partners do not perform any services for public company clients and are, thus, outside the purview of the PCAOB's regulatory authority.[16]

[6] The PCAOB has been granted broad authority to enforce compliance with "accounting" principles, not merely "auditing" standards. This follows from the definition of "professional standards" in Section 2(10) of the Act; it encompasses accounting principles established by the Financial Accounting Standards Board and SEC which are relevant to audit reports for public companies. Previous to the Act, only the SEC had such authority.

[7] The inclusion of the term "other standards" gives the PCAOB authority to adopt rules that may not specifically be within the other specific categories but which are within its broad mandate to protect investors and enhance accurate, informative and independent audit reports.

[8] Adopted in PCAOB Release No. 2003-015, September 29, 2003, and submitted for approval to the SEC.

[9] Proposed for public comment in PCAOB Release No. 2003-023, November 21, 2003.

[10] Proposed for public comment in PCAOB Release No. 2003-017, October 7, 2003.

[11] Section 201 of the Act proscribes the following eight specific non-audit services: (1) "bookkeeping or other services relating to accounting records or financial statements. . .; (2) financial information systems design and implementation; (3) appraisal or valuation services. . .; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker/dealer, investment adviser, or investment banking services; (8) legal services. . . ." It further permits the PCAOB to prohibit "any other services the Board determines, by regulation, is impermissible."

[12] Section 701 of the Act required the U.S. General Accounting Office to study and report on consolidation of public accounting firms. See "GAO Report", *infra*, issued July 2003. Section 704 required the SEC to study and report on enforcement actions involving violations of reporting requirements, including audit failures. It issued its report on January 24, 2003, available at *www.sec.gov/news/studies/sox704report.pdf*. Finally, Section 207 of the Act requires the U.S. Comptroller General "to conduct a study and review of the potential effects of requiring the mandatory rotation of public accounting firms." Its recently published study, GAO-04-216, is available at *www.gao.gov*.

[13] Testimony Concerning the Public Company Accounting Oversight Board, William J. McDonough, before the Committee on Governmental Affairs Permanent Subcommittee on Investigations, United States Senate, Nov. 20, 2003, available at *www.pcaobus.org*, hereafter "McDonough Testimony."

[14] Section 101 of the Act.

[15] For example, in 2002, Deloitte & Touche had 2,618 partners and 19,835 professional staff; Ernst & Young had 2,118 partners and 15,078 professional staff; PricewaterhouseCoopers had 2,027 partners and 16,774 professional staff, and KPMG had 1,535 partners and 10,967 professional staff. See GAO Report, Table 1, page 17.

[16] See Table 1, Twenty Five Largest Accounting Firms by Total Revenue, Partners and Staff Resources (U.S. Operations), 2002 in GAO-03-204, U.S. General Accounting Office Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services,

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In addition, the Act does not prohibit tax and tax related services from being provided by the audit firm to its public company client although each service must be pre-approved by the company's audit committee or directors. These services have included creating tax shelters, structuring other tax avoidance transactions and advising on tax litigation.[17] Such services have been a significant source of revenue for the Big 4 firms.[18] An open question is whether the PCAOB will exercise its authority under the Act to now restrict firms from performing all such services since they are not directly related to the audit.

To some observers, the Act also has an additional limitation by not requiring mandatory rotation of audit firms. While the "lead or coordinating audit partner having primary responsibility for the audit or the audit partner responsible for reviewing the audit" must be changed every five years,[19] the firm itself may continue to serve as auditor indefinitely. Congress asked the GAO to study the issue of whether firm mandatory rotation would enhance audits of public companies by providing a "fresh look" at the financial presentation made. Its report concludes that mandatory firm rotation involves complex issues, including ones of costs versus benefits, and it recommends that the Act's reforms should first be given time to take effect before this issue is resolved.[20]

Will the Act's Reforms and PCAOB's Regulation Be Sufficient to Restore Professionalism? One of the most important questions of accountant regulation is whether professionalism in the large public accounting firms will be restored by reason of the Act's reforms and the new PCAOB regulatory structure created by it. While most interested parties view the Act as a significant reform bound to change accounting firms by improving their performance in conducting audits, one commentator, with long experience in the profession, thinks *not*.

A speech by Professor Arthur R. Wyatt on August 4, 2003 at the American Accounting Association's annual meeting, concluded that "They Just Don't Get It."[21] The "they" are the leaders of the profession, primarily those of the Big 4 firms. He concludes that the profession has, in reality, become a "business" and firms have changed from being associations of professional accountants led by the best of their profession to businesses run by consultants and public relations personnel who are adept as "rainmakers." Moreover, instead of providing leadership in areas of professionalism, ethics and independence, he asserts the American Institute of Certified Public Accountants ("AICPA") has simply evolved into a "trade" association.

Professor Wyatt traces these changes over three periods: First, the period from the 1930s, when the federal securities laws granted the franchise to independent, certified accountants to report on financial statements required to be filed with the SEC, to 1960, when all firms were relatively small. Second, the period of their growth from 1960 to about 1980 when they became more impersonal but still were essentially "accounting" firms. Third, the period since 1980 when they have become multibillion dollar businesses with many on their huge professional staffs not accountants.

For example, Arthur Andersen, the firm Professor Wyatt joined upon graduating from college with an accounting degree, had only 30 partners and each partner knew the other partners and could monitor their work and the firm's reports. In the 1960s, the firm grew to 350 partners, but still was led by the best of its professionals who had risen to the top of the firm because of their "acknowledged know-how, exposure to diverse accounting issues and honed technical skills." At that time, all of its personnel were accountants who had studied accounting before practicing and obtaining their licenses. Education of accountants still focused on "professional responsibilities and the importance of ethical behavior." Their *raison d'etre* was to keep clients out of trouble and "reputations were gained . . . from a firm's policy on how tough a stance to take on the interpretation of accounting standards." By the 1980s, the firm had evolved into a "business" due primarily to two factors. First, the advent of rules permitting the solicitation of business gave rise to active competition between firms for audit and other services. At the same time, the rise of computer technology opened up new services for accountants to perform, mostly unrelated to the audit.

As a result of these developments, Professor Wyatt notes the firms changed in their internal culture and

"Public Accounting Firms, Mandated Study on Consolidation and Competition," July 2003, herein cited as "GAO Report."

[17] Both the Chairman and other members of the PCAOB have indicated in speeches and testimony that "heightened scrutiny" will be given to "audit firms promoting and giving tax opinions on complex, structured transactions for their audit clients." See McDonough Testimony, *supra*. Another Board member has indicated that tax services may violate independence standards and require regulation by the PCAOB if not curbed and corrected, stating: ". . .the marketing to clients of novel, tax-driven, financial products raise serious issues" and that the "auditor almost inevitably becomes an advocate for the client's position that the tax benefits are legitimate. Further, the financial statements may be materially influenced by the supposed tax benefits of the product. Therefore, the auditor may find itself in the position of auditing its own work." See Speech of Board Member Daniel L. Goelzer, September 15, 2003, www.pcaobus.org/speeches.

[18] In 2002, the Big 4 firms had revenues ranging from $979 million to $1.7 billion derived from tax services provided to clients in the U.S. See GAO Report, p. 17.

[19] The SEC has implemented specific partner rotation rules in Securities Act Release No. 33-8183, dated January 28, 2003, and provided guidance on their application in the Office of Chief Accountant's release dated August 13, 2003.

[20] GAO Report 04-216, "Public Accounting Firms: Required Study of the Potential Effects of Mandatory Firm Rotation", November 2003, available at www.gao.gov

[21] Available at the AAA's website, *www.aaa.org* under annual meeting, August 2003.

personnel. Andersen and the other big firms began to hire non-accountants skilled in marketing, computer technology and other non-audit services.

"The end development in this chain was that men and women could become partners in Andersen . . . even though they were not certified public accountants. . . . As the consulting practices grew, the number of non-accounting trained personnel likewise grew. These people were not professionals, but rather they were relatively high-paid personnel with strong skill sets in areas only distantly, or even unrelated to, accounting or auditing. Their numbers grew rapidly, and their success in generating high-margin fees gave them an increasing voice in firm management."

He also states there developed "enormous pressure on the auditing and tax practice, both to grow revenues and to increase margins." Eventually, "greed became a force to contend with in the accounting firms. In essence, the cultures of the firms had gradually changed from an emphasis on delivering professional services in a professional manner to one on growing revenues and profitability." Instead of protecting "investors and creditors from being misled by financial statements that embraced unacceptable accounting and inadequate disclosures," the firms moved to "the top of the list of entities that failed to meet investors' justifiable expectations."

Although he acknowledges the Act's wide scope and Congress' specific intent to correct the problems that led to massive audit failures, Professor Wyatt thinks the legislation will not cure the deeply rooted and underlying malady which afflicts the large firms:

> While that legislation will be helpful in establishing the boundaries on the scope of non-auditing services, and while it helps to establish appropriate qualifications for audit committee members (among other provisions), *the underlying causes of the decline in accounting professionalism remains in place*. The leadership of the various firms needs to understand that the *internal culture* of the firms needs a substantial amount of attention if the reputation of the firm is to be restored. (Italics added).

Thus, Professor Wyatt recommends new leaders, one's skilled in accounting and auditing, who must focus on changing the "internal culture" of their firms; that is, restore the primacy of professional behavior, place greater reliance on quality control, and lead clients to meet the intent of standards rather than engage in financial "engineering."

Some Additional Ideas To Help Restore Professionalism. Obviously, it is in the accounting profession's self-interest to do all it can to restore the highest level of professionalism amongst its personnel. Indeed, the firms may find that future audit failures will result in significant pressure to end their exclusive and highly remunerative franchise of auditing public companies with government auditors replacing them. Hence, the firms have the greatest incentive, their own survival, to see that audit failures are prevented and that the public and regulatory authorities are satisfied with the degree of professionalism they exhibit in their conduct of public company audits.

As for the role of the PCAOB and its threat of "tough love," it will no doubt bring about many needed changes. But, it will be difficult for it to assess whether the "tone at the top" of these large firms has changed or whether compensation of audit partners for quality work is rewarded and promotion based on their audit work. As indicated above, these firms are huge with many professional personnel who are not auditors or who work only on audits of non-public company clients. Due to their size and the intermingling of auditors regulated by the PCAOB with other personnel not regulated, it will be very difficult for the PCAOB to measure who is rewarded in such firms and on what basis. In addition, compensation and promotion policies are inherently subjective and based on factors that cannot easily be measured. For example, interviewing partners and lower level personnel and examining memoranda circulated by the firm is not a particularly reliable means of measuring such intangibles. Indeed, whether a firm is led by the right persons and whether it promotes the highest standards of professionalism can perhaps only be gauged by being within a firm and experiencing on a day to day basis exactly how audit problems are resolved.

In addition, while the rigor of the PCAOB's inspections and its enforcement proceedings may instill greater professionalism in the firms, its limited inspection staff cannot be expected to do more than review a sample of the thousands of audits each of the Big 4 firms conduct. Most audits will not be inspected and some with problems will remain undetected. Moreover, despite the exhortations of the chairman and members of the PCAOB, there are limits to the regulatory process created by the Act noted above and, perhaps, limits to the ultimate sanctions the PCAOB may be able to levy.[22]

In view of these limitations, the author suggests the following additional reforms be considered:

1. Prohibit All Non-Audit Services. First, the PCAOB should consider banning registered public accounting firms from performing any non-audit services for its audit clients, including, as further discussed below, any tax services not directly related to the audit.[23] An outright exclusionary rule will help concentrate the audit firm on the audit itself, which, in turn, should enhance professionalism.

2. Separate the Audit Firm from the Entire Firm. Second, as part of the first reform and to further enhance professionalism, Congress should consider adopting legislation that would require accounting firms performing audits be a separate legal entity of the overall firm with its services limited to auditing. Thus, for example, KPMG would be essentially a holding entity consisting of one partnership called the KPMG *Audit Firm* and a second partnership called the KPMG *Non-Audit or General Services Firm*. The audit firm's personnel would be restricted to partners and staff who are

[22] What "tough love" measures would result has been left unsaid although the chairman of the PCAOB in various interviews has indicated that it will not hesitate to act against a Big 4 firm even at the risk of reducing the public audit market for large companies to three firms. Of course, as the GAO Report suggested, that sanction cannot be easily sustained and regulators might instead "hold partners and employees rather than the entire firm accountable in view of the implications sanctions on the Big 4 firms would have on the audit market." GAO Report at p. 53.

[23] This idea is not new: it was recommended in the separate statement made by several members of the Panel on Audit Effectiveness in its August 31, 2000 Report at Section 5.33.

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CPAs[24] (or new hires training to become CPAs); its revenues would be restricted to the audit and only those limited tax services required to perform audits. Hiring, promotion and compensation would be determined by its own leaders and partners. There would be no participation or ownership interest by its partners in the other partnership called the "Non-Audit or General Services Firm." It too would have its own revenues, hiring, promotion and compensation policies. Overhead and other common costs would be allocated to each firm in proportion to their personnel, size and other factors. If audit personnel need to call upon skills from other experts not in the audit firm, they would do so by contracting with the Non-Audit or General Services Firm or another firm.

Mandating a separate legal structure for the auditing firm probably requires further legislation by Congress.[25] However, since the overall firm would not be broken up, just separated into different legal entities, opposition to this idea should not be a significant political obstacle.[26]

Such a legal separation would not *necessarily* restore professionalism, but it would most probably result in the leadership of the audit firm being chosen from amongst its best accounting professionals. It would also probably lead to promotion and compensation of auditors in line with quality work. Auditors with direct experience in the standards to be met in that area are also more likely to promote changes in the firm's internal culture. Pressure on growing revenues and increasing profit margins to keep up with the non-audit personnel in the other firm would also be lessened considerably. Finally, by having only audit personnel within the regulated firm, the PCAOB can more easily monitor developments within them and gauge whether the firm is striving to achieve the highest level of professionalism.[27]

A change to the legal structure of the largest firms will also not *necessarily* eliminate audit failures from occurring. But, neither will the limited inspection program of the PCAOB provide that cure, nor its bringing of a number of enforcement proceedings with stiff sanctions.[28] A commitment to professionalism and performing its auditing role in a professional manner must come from education, training, mentoring, discipline within the firm and other factors; it is not the product of a legal structure. But, the structure can change the environment of the firm, which, in turn, can help to promote a greater degree of professionalism amongst its personnel.

3. Limit Tax Services by the Audit Firm to Those Directly Related to the Audit. Another idea is for the PCAOB to use its authority under Section 201 of the Act to prohibit a registered firm from performing any tax service to the audit client that is not directly related to the audit. This would address issues of independence that might arise if auditors had to examine financial statements of companies that had adopted tax avoidance structures suggested by the audit firm.

By limiting the tax services that may be provided to the audit client, the problem of aggressive tax shelters and other tax avoidance schemes would not disappear but be relegated to the other legal entity. That non-audit firm providing tax services to non-audit clients would have to meet with enhanced IRS regulation and public scrutiny. Thus, this is not a solution to the overall problem, but a way for regulated audit firms to be restricted in the tax services they provide to public company clients so that such services are directly and exclusively related to the audit. This too should help the audit firm concentrate on the audit and enhance professionalism.

4. Require Audit Team Members to Certify the Audit Meets Professional Standards. A further idea is for the PCAOB to adopt a rule that requires each partner and senior level accountant that performs substantial work on an audit to sign a certificate that he/she has performed the audit in accordance with applicable professional standards. This would be in addition to the standard report signed by the firm. The idea of individual certification has been adopted for management as a way to improve financial reporting. Thus, Section 302 of the Act requires the chief executive and financial officers to sign each quarterly and annual report indicating the financials are not misleading and fairly present the company's financial condition and results of operation. A knowingly false certification is a criminal offense under Section 906 of the Act.[29]

In view of these stringent requirements imposed on management's top officers, it would not be unreasonable for the audit team's significant members to sign a certification as to their work and knowledge. At the same time, taking individual responsibility for an audit, and not simply signing the firm's name to the report, might significantly concentrate each auditor on the responsibilities being undertaken and the public trust re-

[24] A limited number of tax attorneys assisting auditors in tax related audit work would also be permitted personnel. The audit firm would also perform audits for non-public companies.

[25] While it may be argued that the Act gives the PCAOB authority under Section 101(a) "to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports," nothing therein relates to power to regulate the legal structure of public accounting firms.

[26] A legal challenge to such legislative separation of the firms might be mounted on grounds that the federal government has no power to regulate such firms under the Constitution's "commerce clause" but since the firms are national in scope and affect interstate commerce that argument lacks merit. The principal legal justification for such separate firms is the same as that underpinning the Sarbanes-Oxley Act, i.e. the need to protect public investors from audit reports that fail to meet professional standards.

[27] An ancillary and long term effect of such legal separation might be greater competition in the public company audit market since the largest audit firms would be reduced in size by such separation while other firms might consolidate and rival them in size. See GAO Report at p. 17.

[28] For example, in the five year period ended July 30, 2002, the SEC commenced 57 administrative or federal court proceedings against accounting firms or about 10 per year but this has not stopped audit failures from occurring. SEC Report Pursuant to Section 704 of the Sarbanes-Oxley Act, Jan. 24, 2003 at *www.sec.gov/news/studies/sox704report.pdf.*

[29] Such officers also must take responsibility for establishing and maintaining internal controls over financial reporting and certify that they have disclosed all significant deficiencies therein to the audit committee and auditors. Under Section 404(a) of the Act, they also must assess the company's internal controls and system once annually and opine as to their effectiveness.

posed in their professional judgment. Too many auditors believe that they are not personally liable, only the firm is, and the firm's insurance policy will take care of any monetary liability.[30] This mentality would change if personnel realized more directly that they might individually also be liable for defective audit work. Finally, as with officer liability under Section 906 of the Act, imposing criminal liability on accountants for a knowingly false certification is bound to have a substantial impact on the degree of diligence taken by each professional signing the certification.

Conclusion. Restoring professionalism in public accounting firms is not only in the public interest but also in the vital self-interest of the firms if they are to retain the franchise granted to them in the federal securities laws to audit and certify the financial statements of public companies. To enhance the level of professionalism in these firms, four additional reforms should be considered. First, the PCAOB could prohibit all non-audit services from being performed by a registered audit firm except for tax services directly related to the audit. Second, Congress could mandate the legal separation of the audit firm from the rest of the firm. Third, all non-audit related tax services could be prohibited by the PCAOB from being performed by the audit firm. Fourth, the PCAOB could require individual auditors to also certify that the audit was conducted in accordance with professional standards and Congress could impose criminal liability for a knowingly false certification. Taken together, these four measures should improve the level of professionalism in the audit firms and help prevent further audit failures.

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[30] To insure that firms do not cushion the impact of liability through insurance policies, insurers could insist such policies contain very large deductibles.

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