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STATEMENT OF

Bill Gradison

Obtaining both audit and tax services from the same firm often proves helpful to issuers in light of the auditor’s detailed knowledge of the issuer’s business. As a result, whether an issuer’s auditor is engaged to provide tax advice is properly left to the discretion of the audit committee. I support the proposal before the Board. It provides useful and targeted approach to auditor independence. There are, however, other issues – apart from independence and ethics per se – which arise when the auditor provides tax services, issues which relate to audit quality.

On the plus side, when an audit firm provides both tax advice and attestation services, the engagement team may be assumed to have full and timely access both to the tax advisor and to the tax advice given to the issuer. This information would not necessarily be as readily available as if the tax advice were received by the issuer from another source. In addition, the audit committee, by pre-approving specific tax services performed by the auditor, would know which tax issues are under consideration by management and, knowing this, would be in a position to review with the auditor the advice given to management. This, in turn, would enable the audit committee to provide enhanced oversight of issues relating to differences in tax and book accounting, positions taken in the filing of tax returns and, more specifically, the provision for taxes in the financial statements.

On the negative side, there is the risk that the engagement team may not exercise the same level of due care and professional skepticism in situations where the tax advice followed by management came from their own firm. This might occur because of the auditor’s high regard for the competence of the firm’s tax specialists or from the auditor being reluctant to be seen as questioning the advice given by the firm’s tax advisors. Under current PCAOB standards, the auditor has the obligation to obtain sufficient competent evidence to form and support an opinion as to the propriety of the issuer’s accounting for taxes. Tax matters are material to most issuers’ financial results and often require highly subjective judgments regarding, for example, the future resolution of tax contingencies and future levels of taxation. In many cases, this combination of factors results in a high level of risk that requires a correspondingly high level of audit evidence to support an auditor’s assessment of the issuer’s accounting for income taxes.
There is the further risk, which indeed is an independence issue, that the engagement team will not probe into management’s ability and willingness to make the tax decisions itself, especially if the tax advice comes from the auditor’s own firm. Receiving advice is not the same as understanding advice and deciding whether to follow that advice.1

For services not already prohibited by the auditor independence rules, the apparent conflict between providing tax services that are used by management and the independence principle of not auditing one’s own work is reconciled by the Board’s interim independence standards: “In particular, care should be taken not to perform management functions or make management decisions for the attest client, the responsibility of which remains with the client’s board of directors and management” (ET 101-3, as of April 16, 2003).2

The rules before us are an important part, but only a part, of audit standards bearing upon the relationship between audit quality and tax services. In addition to the proposal the Board is considering today, and other current Board standards, there may be others on the horizon which could enhance the quality of the auditing of tax provisions. I have in mind communications with audit committees which may be on the Board’s agenda next year.

The Board’s standard on internal controls (Auditing Standard 2) also should be mentioned in this regard. Internal controls over the reporting of tax reserves require the same level of scrutiny by management as other internal controls. This matter was highlighted in May of this year by Jefferson Wells International and the Institute of Internal Auditors in their Sarbanes-Oxley Implementation Survey. In the portion of the report on gaps in internal controls they state: “There is also evidence that controls within the tax area tend to receive less attention than they warrant. Federal taxes, state sales taxes and state property taxes, for example, usually originate from a diverse range of feeder systems. Each of these information sources, as well as the subjective judgments used to determine tax exposure, require effective controls and processes.”

As I see it, PCAOB’s main role in assuring that the provision of tax services enhances, or at least does not weaken, audit quality may come through the inspection process. Future inspection reports may help inform the Board of the impact on audit quality of the Board’s standards relating to tax services and assist the Board in determining whether

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1 Interpretation 101-3, which was adopted by AICPA after the Board adopted its interim standards, states, “In cases where the client is unable or unwilling to assume these responsibilities (for example, the client does not have an individual with the necessary competence to oversee the nonattest services provided, or is unwilling to perform such functions due to lack of time or desire), the [AICPA’s] member’s provision of these services would impair independence.”

2 Furthermore, under ET 101-3 provisions (also adopted by the AICPA after the Board adopted its interim standards) when tax services are provided by the auditor the engagement team has the responsibility to make a determination as to whether management has carried out its responsibilities under ET 101-3 and to document the work performed in making that determination. The standard is quite clear that if management has failed to carry out its responsibilities, an independence violation exists. Consequently, the auditor would be unable to render an opinion.
additional steps need to be taken with regard to the role that auditors play in providing tax services to their audit clients.

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