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"Tax Services" as a Trojan Horse in the Auditor Independence Provisions of Sarbanes-Oxley

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TABLE OF CONTENTS

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* Professor of Law, Notre Dame Law School. B.B.A. 1982; J.D. 1985, University of Notre Dame. C.P.A. (inactive) 1987, Ohio. The author gratefully acknowledges valuable research assistance from John J. Barber and Vincent G. Kalafat and helpful comments, insights or suggestions from Kathy Amer, Rob Becht, Alan Gunn, David R. Herwitz, Brian Neach, Ryan Painter, Angela Petrucci, Thomas L. Shaffer, James A. Sullivan, and Bernard Wolfman. Significant sections of this article are adopted from Matthew J. Barrett, *Enron and Andersen—What Went Wrong and Why Similar Audit Failures Could Happen Again*, *in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 155 (Nancy B. Rapoport & Bala G. Dharan eds., 2004). Although I teach law students and consider myself a member of the "tax bar," I write this article as a member of both the accounting and legal professions. I believe that investigators have found, or could find, the "fingerprints" and failings of both accountants and lawyers in every one of the audit failures involving the recent financial frauds. *Cf.* Kip Dellinger, *Critique of Tax Bar Clarified*, 99 TAX NOTES 155 (2003) ("behind each and every one of the well-publicized audit failures we have lawyers").

INTRODUCTION

According to Greek legend, Paris, a prince of Troy, visited the Greek city of Sparta, where he fell in love with Helen, the wife of Menelaus, the King of Sparta. Paris abducted Helen. In an effort to reclaim her, the Greeks assembled about 100,000 warriors and sent a vast fleet to attack Troy, giving rise to the Trojan War. After an unsuccessful ten-year siege, a famous ruse eventually ended the conflict. Before seemingly sailing away, the Greeks built a huge wooden horse and left it outside the gates to the city of Troy as a "gift." Unknown to the Trojans, the Greeks had hidden several soldiers in the horse. After demolishing a wall to the city, the Trojans dragged the horse into Troy. At night, the hidden Greek soldiers emerged from the horse and opened the gates to the city, allowing the returning Greek army to capture and burn the city.[1] Over the years, the term "Trojan horse" has come to refer to "gifts" or other factors likely to undermine an established institution.[2]

In response to the financial scandals at Enron, WorldCom, and other publicly traded companies that beleaguered our nation's economy and securities markets in the early 2000s, Congress enacted the Sarbanes-Oxley Act of 2002 (SOx).[3] Specifically denominated as "[a]n Act [t]o protect investors,"[4] SOx sought to restore investor confidence and to rebuild integrity in the auditing profession. In particular, SOx enacted several reforms designed to enhance auditor independence. Among other provisions, SOx

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1. *See* 27 THE ENCYCLOPEDIA AMERICANA 134 (int'l ed. 1999).

2. *See* WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 2451 (unabr. ed. 1986). Other dictionaries capitalize the first letter, and this article follows that convention. *See, e.g.*, WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 1264 (1984).

3. Pub. L. No. 107-204, 116 Stat. 745 (to be codified at scattered sections of 15, 18, 28 & 29 U.S.C.).

4. Sarbanes-Oxley Act, pmbl., 116 Stat. at 745.

requires a public company's audit committee to preapprove all audit and non-audit services and specifically bars auditors[5] from providing certain services to publicly traded audit clients.[6] Although Congress considered a complete prohibition that would have prevented auditing firms from providing any non-audit services, including so-called "tax services,"[7] to audit clients, Congress ultimately decided both against an absolute bar on non-audit services and to omit tax services from the list of prohibited services. As a result, as long as the audit committee preapproves the engagement, SOx generally allows an auditor to provide tax services to an audit client.[8] Knowledgeable observers might note that the accounting industry spent $41 million on lobbying activities between 1997 and 2001, mention that each of the then Big Five accounting firms ranked among the top twenty contributors to George W. Bush's 2000 presidential campaign, and point out that those firms contributed to 212 of the 248 Senate and House members who served on Congressional committees involved in the numerous investigations that began after the recent financial scandals.[9] Interestingly, even *The Wall Street Journal* has reported that the auditing industry "successfully lobbied Congress to specifically sanction the offering of traditional tax-planning services and tax advice—one of the largest and most lucrative nonaudit services provided by accounting firms."[10]

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5. SOx uses the term "public accounting firm" to refer to a proprietorship, partnership, or other legal entity engaged in the practice of public accounting or preparing or issuing audit reports. Sarbanes-Oxley Act § 2(a)(11) (to be codified at 15 U.S.C. § 7201(a)(11)). In addition, most prohibitions in SOx also apply to any person associated with a public accounting firm. *See, e.g.*, Sarbanes-Oxley Act § 201 (to be codified at 15 U.S.C. § 78j-1(g)). This article uses the term "auditor" to refer to both accounting firms that audit public companies and individual auditors and other professionals at those firms.

6. One important caveat to this discussion: SOx and the federal securities laws generally do not apply to closely held companies and not-for-profit organizations that may require audited financial statements to obtain bank loans or for other reasons. Those enterprises and their auditors remain beyond the SEC's reach. *See* DAVID R. HERWITZ & MATTHEW J. BARRETT, MATERIALS ON ACCOUNTING FOR LAWYERS 171 (3d ed. 2001).

7. As an umbrella term, a reference to "tax services" covers a broad range of services, ranging from tax compliance work, such as preparing tax returns, to sophisticated tax minimization strategies, or "tax shelters," that aggressively seek to use quirks in the Internal Revenue Code to avoid taxes. *See* Sheryl Stratton, *Could Enron Collapse Lead to Big 5 Losing Tax Work?*, 94 TAX NOTES 812 (2002); *see also infra* notes 160–61 and accompanying text.

8. *See infra* notes 51–57 and accompanying text.

9. *See* James D. Cox, *Reforming the Culture of Financial Reporting: The PCAOB and the Metrics for Accounting Measurements*, 81 WASH. U. L.Q. 301, 316 (2003).

10. Michael Schroeder, *SEC Clears Rules Limiting Auditors from Offering Consulting Services*, WALL ST. J., Jan. 23, 2003, at C9.

SOx also authorized the Securities and Exchange Commission (SEC) and the newly created Public Company Accounting Oversight Board (PCAOB) to promulgate additional regulations and rules to implement statutory provisions and to strengthen existing administrative requirements or professional standards regarding auditor independence.[11] As a result, even after SOx's enactment, considerable debate has continued as to whether an auditor's provision of tax services to an audit client impairs the auditor's independence.[12] While the release that accompanied the SEC's proposed rules to implement SOx's reforms to strengthen auditor independence raised the possibility that the SEC might ban certain tax services involving so-called "tax shelters,"[13] the SEC ultimately concluded that the difficulty in defining a tax shelter counseled against a blanket prohibition.[14] More significantly, the subsequent release that announced the SEC's final rules specifically reiterated the agency's "long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence."[15]

As the most vocal advocate in the legal academy for increased auditor independence, Professor Bernard Wolfman has repeatedly argued that a conflict of interest arises anytime an auditor offers significant tax advice to an audit client or promotes a tax shelter to anyone.[16] Accordingly, he has urged

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11. SOx established the PCAOB to register, regulate, and inspect public accounting firms that audit publicly traded companies, which the legislation refers to as "issuers" or "registrants"; to establish or adopt auditing, quality control, ethics, independence, and other standards; and to conduct investigations and disciplinary proceedings when appropriate to enforce compliance with the law and professional standards. *See* Sarbanes-Oxley Act § 101 (to be codified at 15 U.S.C. § 7211). Perhaps most significantly, SOx ended accountant self-regulation.

12. *See* Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6006, 6016 (Feb. 5, 2003) [hereinafter Final Rules].

13. *See* Strengthening the Commission's Requirements Regarding Auditor Independence, 67 Fed. Reg. 76,780, 76,790 (Dec. 13, 2002) [hereinafter Proposed Rules]. See *supra* note 7 for more explanation about "tax shelters."

14. *See* Schroeder, *supra* note 10.

15. Final Rules, *supra* note 12, at 6017.

16. *See, e.g.*, Bernard Wolfman, *The Best Way to Protect Auditor Independence*, 89 TAX NOTES 1779 (2000) [hereinafter Wolfman, *The Best Way*] (arguing that any tax advice that an auditor provides to any client may impair the auditor's independence); Bernard Wolfman, *Auditors: Stick to Your Auditing*, 96 TAX NOTES 298 (2002) [hereinafter Wolfman, *Stick to Your Auditing*] (urging the Senate to pass legislation that would include tax advice among the non-audit expert services that auditors may not provide to audit clients); Bernard Wolfman, *Wolfman's SEC Auditor Independence Rules Comments*, TAX NOTES TODAY, Jan. 23, 2003, *available on* LEXIS at 2003 TNT 15-63 [hereinafter Wolfman, *Auditor Independence Rules*] (recommending that the SEC prohibit an auditor from performing "all tax services other than return preparation and compliance work"); Bernard Wolfman, *SEC Let Investors Down*, 98 TAX NOTES 1019 (2003) [hereinafter Wolfman, *SEC Let Investors Down*] (opining that the SEC "has

the SEC and Congress to prohibit auditors for public companies from promoting tax shelters or providing tax planning and consulting services.[17] Going beyond Professor Wolfman's recommendations, this article asserts that auditors for public companies should also not provide tax compliance services to audit clients or their executives. Accordingly, this article argues that SOx's failure to prohibit auditors for public companies[18] from both providing tax services to audit clients or their executives and selling tax shelters to anyone presents a Trojan horse that threatens both the investing public and the auditing profession.

To the extent that conflicts of interest cause audit failures, SOx leaves an important gap in its reforms to enhance auditor independence by failing to prohibit such activities. Moreover, the attempts to increase auditor independence do not adequately address unconscious bias, the propensity to interpret data in accordance with one's desires,[19] and a tendency that legal scholars often refer to as *cognitive bias*.[20] As long as financial or other incentives tempt auditing firms and their executives and employees to try to retain or obtain engagements with audit clients, whether those engagements involve tax services, other permissible non-audit services, or future audit services, either this unconscious bias or the conflicts of interest arising from tax engagements could lead to future audit failures.[21] In particular, these financial and other incentives can potentially influence an auditor's decision to acquiesce in a questionable accounting practice. While management can no longer hire or fire the auditor, under the guise of increasing auditor independence, management can use "enhanced independence" to support a recommendation to the audit committee to hire another firm to provide tax

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left the investing public in the lurch").

17. Wolfman, *Auditor Independence Rules*, *supra* note 16; Wolfman, *SEC Let Investors Down*, *supra* note 16.

18. By limiting this proposal to public companies, this proposal seeks to avoid adverse effects on small businesses. Many small businesses and their owners or creditors, however, may conclude that enterprise should not retain the same firm to provide both auditing and tax services. *See* Stratton, *supra* note 7.

19. *See* Max H. Bazerman et al., *Why Good Accountants Do Bad Audits*, HARV. BUS. REV., Nov. 2002, at 96.

20. *See, e.g.*, Richard W. Painter, *Convergence and Competition in Rules Governing Lawyers and Auditors*, 29 J. CORP. L. (forthcoming summer 2004) (describing cognitive bias and arguing that regulators have not attempted to understand how these biases affect gatekeepers or how regulation can best account for such biases).

21. Unconscious bias also suggests the potential need to require mandatory rotation of audit firms after fixed terms for predetermined fees to minimize the threat that a public company can fire or otherwise punish the auditor for failing to approve questionable accounting practices. *See* Bazerman et al., *supra* note 19, at 102. This article, however, will not address mandatory audit firm rotation.

services, other permissible non-audit services, or future audit services. Thus, if the auditor does not approve, or at least acquiesce in, certain accounting treatments or disclosures that management prefers, the auditor conceivably jeopardizes potentially significant future professional fees.[22]

Part I of this article discusses the provisions in SOx that enhance auditor independence. Part II examines the SEC's rulemaking efforts to implement those reforms and several subsequent developments. Part III explains why conflicts of interest and unconscious bias remain problems in a post-SOx world. Part IV presents and evaluates various arguments regarding whether or not auditors should provide any tax services. Ideally, auditors for public companies should simply stick to auditing. Ultimately, this section concludes that such auditors should neither provide tax services to audit clients or their executives nor promote tax shelters to anyone. When an audit client purchases a tax shelter that materially affects its tax expense and liabilities from its auditor, the accounting firm must audit its own advice, which impairs its independence. Because accounting firms tend to sell similar tax-shelters, even the attempt to sell a similar tax shelter to a non-audit client also impairs auditor independence. When officers of audit clients purchase such tax shelters, the accounting firm arguably must perform incompatible roles—the audit requires the accounting firm to act as a watchdog of management at the same time that the firm must act as an advocate for the officer in the tax matter. In any situation in which the auditor expresses an opinion on a tax matter, the auditor must review its own work. Even routine tax compliance work often requires the auditor to assume an advocacy role for the client. In an effort to avoid such possibilities, an auditor should not offer any tax services to an audit client.

Accordingly, Part IV urges individual auditors, auditing firms, the auditing profession, audit committees, directors, investors (especially institutional investors), the PCAOB, and the SEC to take any necessary actions to prevent conflicts of interest and the desire to retain or obtain tax engagements from further damaging the auditing profession's integrity, the public's confidence in the capital markets in this country, and the U.S. economy generally. If individual auditors, auditing firms, audit committees, boards of directors, and investors do not respond to this continuing threat to auditor independence, this article recommends that the PCAOB and the SEC adopt and approve regulations that treat both performing tax services for audit clients or their executives and offering or promoting tax shelters as impermissible activities for registered public accounting firms. Without vigilance from all involved, SOx's auditor independence provisions create a

22. *See generally* HERWITZ & BARRETT, *supra* note 6, at 173–74, 192–93.

Trojan horse that threatens both the auditing profession and the investing public.

I. REFORMS IN SARBANES-OXLEY REGARDING AUDITOR INDEPENDENCE

Even though SOx enacted numerous reforms in an effort to protect investors, the legislative history explicitly states that the provisions regarding auditor independence stand "at the center of this legislation."[23] Since the 1930s, the federal securities laws have required an *independent* public accountant to attest to financial statements filed with the SEC.[24] In fact, the belief in the auditor's independence from the audit client has historically provided the justification for the investing public's confidence in the integrity of financial statements that public companies must file.[25] Therefore, while the federal securities laws grant a franchise to independent auditors,[26] important responsibilities accompany that franchise. In *United States v. Arthur Young & Co.*,[27] an unanimous Supreme Court recognized that:

> [T]he independent auditor assumes a *public* responsibility . . . [The auditor] 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.[28]

Based on SEC statistics, the Senate Report that accompanied the bill that eventually became SOx observed that the percentage of average revenue at the then Big Five[29] accounting firms arising from accounting and auditing services fell from fifty-five percent in 1988 to thirty-one percent in 1999.[30] By comparison, the percentage of average revenue coming from management consulting services increased from twenty-two percent to fifty percent during that same period.[31] The most recent data that the SEC reported to Congress

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23. S. REP. NO. 107-205, at 14 (2002).

24. *See, e.g.*, Securities Act of 1933, sch. A(25), 15 U.S.C. § 77(aa)(25) (2000); Securities Exchange Act of 1934, § 13(a)(2), 15 U.S.C. § 78m(a)(2) (2000).

25. *See* S. REP. NO. 107-205, at 14 (2002).

26. Significantly, federal law does not require an issuer to employ a law firm, an underwriter, or any other type of professional. *See id.* (citing testimony from Richard Breeden, a former SEC Chairman).

27. 465 U.S. 805 (1984).

28. United States v. Arthur Young & Co., 465 U.S. 805, 817–18 (1984).

29. After its conviction on one felony count of obstructing justice, Arthur Andersen LLP (Andersen) voluntarily stopped auditing public companies, leaving four major accounting and professional services firms (collectively, the "Big Four" or the "Final Four").

30. *See* S. REP. NO. 107-205, at 14 (2002).

31. *See id.* at 14–15.

showed that, on average, non-audit fees comprised seventy-three percent of the total fees of public accounting firms.[32] In other words, public accounting firms charged $2.69 in non-audit fees for every $1.00 in audit fees.[33] In essence, auditing had become a "loss leader" to more profitable consulting services.[34] Because more than one hundred million investors in the United States rely on audited financial statements to reach investment decisions, Congress enacted measures that sought to ensure that accounting firms auditing public companies maintain their independence from their audit clients and uphold the public trust.[35]

In an effort to reduce conflicts of interest,[36] SOx contains at least six different provisions designed to strengthen various requirements regarding auditor independence for public companies.[37] These provisions affect audit committees, prohibited services, pre-approval requirements, audit partner rotation, conflicts of interest, and implementing regulations.[38] In addition, SOx directed the Comptroller General to study the potential effects arising from requiring mandatory audit firm rotation.[39]

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32. *See id.* at 15.

33. *See id.*

34. *See generally* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1410–12 (2002).

35. *See* S. REP. NO. 107-205, at 14, 19 (2002).

36. Even after SOx, an arguably inherent conflict of interest remains because the issuer undergoing the audit must pay the audit fee. *See id.* at 14.

37. The legislation specifically instructs appropriate State regulatory authorities to determine independently the proper standards that should apply to small and medium-sized accounting firms that do not register with the PCAOB. SOx explicitly provides that State regulatory authorities should not presume that the standards applicable to registered public accounting firms also apply to firms that do not audit issuers. The Act urges State regulators to consider the size and the nature of the accounting firms they supervise and the size and nature of those firms' clients. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 209, 116 Stat. 745, 775 (to be codified at 15 U.S.C. § 7234).

38. *See infra* notes 40–46 and 48–60 and accompanying text.

39. *See* Sarbanes-Oxley Act § 207 (to be codified at 15 U.S.C. § 7232). In addition, SOx directed the Comptroller General to submit a report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services about the potential effects of requiring the mandatory rotation of auditing firms not later than one year after the legislation's enactment. *See id.* GAO subsequently submitted a report summarizing an extensive survey directed to the chief financial officers at more than 1,150 public companies, the audit committees at those companies, and more than 600 auditing firms. *See* U.S. GEN. ACCOUNTING OFFICE, PUBLIC ACCOUNTING FIRMS: REQUIRED STUDY ON THE POTENTIAL EFFECTS OF MANDATORY AUDIT FIRM ROTATION, GAO-04-216, at 3, 4, 8 (2003), *available at* http://www.gao.gov/new.items/d04216.pdf (last visited Mar. 25, 2004) (concluding that costs from increased audit fees and the loss of institutional knowledge acquired by a public company's previous auditor under mandatory audit firm rotation likely outweigh any benefits from enhanced auditor independence).

Although outside the title in SOx captioned "Auditor Independence,"[40] perhaps most significantly, the legislation directed the SEC to prescribe rules that prohibit the national securities exchanges and national securities associations from listing any issuer that does not satisfy certain standards relating to audit committees.[41] Once effective, the new listing standards will require those public companies that list their shares on national securities exchanges and associations, including the New York Stock Exchange (NYSE) and The Nasdaq Stock Market, Inc. (Nasdaq), to give their audit committees direct responsibility to hire, compensate, oversee, and fire the independent auditor.[42] In addition, the new listing standards will only allow independent directors to serve on audit committees.[43] To qualify as independent, a board member generally cannot accept any consulting, advisory, or other compensatory fee from the issuer.[44] In a further effort to empower audit committees, another SOx provision requires a registered accounting firm performing an audit for a public company to report timely to the company's audit committee about the critical accounting policies and practices affecting the company's financial statements; all alternative treatments within generally accepted accounting principles that the auditor has discussed with management; any accounting disagreements between management and the auditor; and any other material written communications between the auditor and management.[45]

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40. *See* Sarbanes-Oxley Act, tit. II (to be codified at 15 U.S.C. §§ 78c(a), 78j-1).

41. *See* Sarbanes-Oxley Act § 301 (to be codified at 15 U.S.C. § 78j-1(m)). The term "audit committee" refers to a committee of a public company's board of directors that oversees both the accounting and financial reporting processes and the audits of the company's financial statements. If a public company has not created such a committee, the term refers to the entire board of directors. *See* Sarbanes-Oxley Act § 2(3) (to be codified at 15 U.S.C. § 7201(a)(3)).

42. *See* Sarbanes-Oxley Act § 301 (to be codified at 15 U.S.C. § 78j-1(m)). The SEC issued final rules on April 9, 2003 and then approved listing standards pursuant to those rules on November 4, 2003. *See* Standards Relating to Listed Company Audit Committees, 68 Fed. Reg. 18,788 (Apr. 16, 2003); Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Changes (SR-NYSE-2002-33 and SR-NASD-2002-141), 68 Fed. Reg. 64,154 (Nov. 12, 2003) [hereinafter NYSE and NASD Rulemaking Relating to Corporate Governance]. *See infra* notes 82–85 and accompanying text.

43. *See* Sarbanes-Oxley Act § 301 (to be codified at 15 U.S.C. § 78j-1). SOx also mandates that the standards require listed companies to establish procedures for their audit committees to handle complaints about accounting, internal accounting controls, or auditing matters; to authorize the audit committee to retain independent counsel and other advisors; and to provide appropriate funding to pay for the independent audit and to compensate any advisors. *See id.*

44. *See id.*

45. *See id.* § 204 (to be codified at 15 U.S.C. § 78j-1(k)).

Second, SOx prohibits auditors from providing certain services to audit clients subject to the SEC's jurisdiction.[46] The legislative history states that three basic principles informed the list of prohibited activities that Congress established for registered public accounting firms that audit public companies. To qualify as independent, *an auditing firm: (1) should not audit its own work; (2) should not function as part of client management or as a client employee; and (3) should not act as an advocate for the audit client.*[47] The "prohibited activities" for auditors include bookkeeping or other services related to the audit client's accounting records or financial statements; financial information systems design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; internal audit outsourcing services, management functions, or human resources; legal and expert services unrelated to the audit; and any other service that the PCAOB decides to prohibit via regulation.[48] Subject to the SEC's approval, the last category explicitly gives the PCAOB the authority to add "prohibited activities" to the list.[49] If a registered public accounting firm provides any of the listed services to an audit client who is also an issuer, the audit firm likely would not only jeopardize its independence from the audit client, but also violate federal securities laws, SEC regulations, and PCAOB rules.[50] As described more fully below, an auditor may perform services not included on the prohibited list, including tax services, for an audit client only if the client's audit committee approves those services in advance.[51]

Third, SOx generally requires an issuer's audit committee to preapprove all services, both audit and non-audit, that a registered public accounting firm provides to an audit client.[52] This requirement specifically applies to any non-prohibited services. The statute allows the audit committee to delegate the authority to grant pre-approvals to one or more designated members, as long as any designee also qualifies as an independent director and any resulting approvals come before full audit committee at each of its scheduled

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46. *See id.* § 201 (to be codified at 15 U.S.C. §§ 78j-1, 7231).

47. *See* S. REP. NO. 107-205, at 18 (2002).

48. *See* Sarbanes-Oxley Act § 201(a) (to be codified at 15 U.S.C. §§ 78j-1(g), 7231). On a case by case basis and subject to the SEC's review, the PCAOB may exempt any person, issuer, public accounting firm, or transaction from these prohibitions to the extent necessary to protect investors and to advance the public interest. *See id.* § 201(b) (to be codified at 15 U.S.C. § 7231).

49. *See id.* § 107(b) (to be codified at 15 U.S.C. § 7217(b)).

50. *See id.* SOx, however, does give the PCAOB the authority to grant exemptions on a case by case basis. *See supra* note 48.

51. *See infra* notes 52–57 and accompanying text.

52. *See* Sarbanes-Oxley Act § 201 (to be codified at 15 U.S.C. §§ 78j-1, 7231).

meetings.[53] In addition, the statute allows a *de minimis*[54] exception to the pre-approval requirement when an auditor provides services which the issuer did not recognize at the time of the engagement as non-audit services, and the aggregate amount of all such non-audit services that the auditor provided to the issuer did not exceed five percent of the total amount that the issuer paid to its auditor during the fiscal year in which the auditor provided the non-audit services.[55] After either the issuer or the auditor promptly brings such services to the audit committee's attention, the audit committee can approve these services before the auditor completes the audit.[56] Once again, if the audit committee delegates such approval authority to one or more of its members, those members may grant the approval necessary for the *de minimis* exception.[57] In addition to satisfying the pre-approval requirement, issuers must disclose the amounts paid to auditors for various types of services.[58]

Fourth, SOx codifies previous auditing standards that required audit partner rotation. Under the new statutory provisions, a registered public accounting firm must rotate the lead partner and the review partner on any audits of public companies so that no partner performs an audit on the same issuer as a lead partner or review partner for more than five consecutive years. In other words, SOx provides that most accounting firms may not provide audit services to an issuer if the lead audit partner or the reviewing audit partner has performed audit services for the issuer in each of the issuer's previous five fiscal years.[59]

Fifth, in an effort to eliminate certain conflicts of interest, SOx imposes a "cooling-off period" that effectively prevents public companies from hiring members of the audit team in certain high-level positions, including chief executive officer, controller, chief financial officer, chief accounting officer, and equivalent positions. As a result, SOx prevents an auditing firm from auditing an issuer that employs, in certain high-level positions, an individual who worked on the issuer's audit during the one year period before the audit services begin.[60]

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53. *See id.* § 202 (to be codified at 15 U.S.C. § 78j-1(i)(3)).

54. SOx incorrectly spells the word "de minimus." *Id.* § 202 (to be codified at 15 U.S.C. § 78j-1(i)(1)(B)).

55. *See id.* (to be codified at 15 U.S.C. § 78j-1(i)(1)(B)(i)).

56. *See id.* (to be codified at 15 U.S.C. § 78j-1(i)(1)(B)).

57. *See id.* (to be codified at 15 U.S.C. § 78j-1(i)(3)); *see also supra* note 54.

58. *See* Sarbanes-Oxley Act § 202 (to be codified at 15 U.S.C. § 78j-1(i)(2)).

59. *See id.* § 203 (to be codified at 15 U.S.C. § 78j-1(j)).

60. *See id.* § 206 (to be codified at 15 U.S.C. § 78j-1(*l*)).

II. SUBSEQUENT DEVELOPMENTS REGARDING AUDITOR INDEPENDENCE

In response to the directives in SOx, the SEC issued final regulations regarding auditor independence, minimum listing standards related to audit committees, and improper influence on the conduct of audits. In addition, several recent revelations concerning situations where auditors provided tax services to audit clients or client management have further tarnished the accounting profession's reputation and raised additional concerns about auditor independence when auditors provide tax services to audit clients or their executives or promote tax shelters.

A. Regulatory Actions

Pursuant to the directive in SOx to the SEC to issue final regulations to strengthen auditor independence within 180 days after enactment,[61] the SEC timely issued final regulations on January 28, 2003.[62] Initially, these regulations, which generally became effective on May 6, 2003,[63] amended the Code of Federal Regulations to reflect SOx's new rules on prohibited services.[64] The same three principles that informed the list of prohibited activities that Congress established for auditors in SOx essentially provide the predicate for the SEC's final rules.[65] After the release accompanying the rules that the SEC originally proposed suggested that audit committees keep in mind these basic principles in determining whether to allow the auditor to provide tax services,[66] several commentators observed that such a recommendation "would significantly alter the Commission's historic position related to tax services."[67] Even though the release accompanying the SEC's final rules did not specifically address this observation on the merits, the SEC did reiterate its "long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence."[68]

61. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 208(a), 116 Stat. 745, 775 (to be codified at 15 U.S.C. § 7233).

62. *See* Final Rules, *supra* note 12. About two months later, in March 2003, the SEC issued technical corrections to these rules. *See* Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 15,354 (Mar. 31, 2003).

63. *See* Final Rules, *supra* note 12. The regulations, however, contain various transitional rules. *See id.* at 6006, 6047 (codified at 17 C.F.R. § 210.2-01(e) (2003)).

64. *See supra* notes 46–58 and accompanying text.

65. *See* Final Rules, *supra* note 12, at 6010; *see also supra* note 47 and accompanying text.

66. *See* Proposed Rules, *supra* note 13, at 76,790.

67. Final Rules, *supra* note 12, at 6017.

68. *Id.*

The SEC reasoned that SOx expressly states that auditors may provide certain non-audit services to audit clients "including tax services . . . only if the activity is approved in advance by the audit committee."[69]

Although neither SOx nor the SEC's final rules on auditor independence explicitly define "tax services," the release accompanying the SEC's final rules specifically mentioned "tax compliance, tax planning, and tax advice" as permissible non-audit services, assuming that the audit committee has preapproved such services.[70] The SEC's release, however, cautioned that simply labeling a service as a tax service does not automatically eliminate the potential to impair independence. In that vein, the SEC warned both audit committees and accountants that certain tax services could or would impair an auditor's independence. In particular, the SEC's release unequivocally stated that "representing an audit client before a tax court, district court, or federal court of claims" *would* impair independence.[71] In addition, the SEC's release encouraged audit committees to scrutinize carefully any engagement in which the auditor recommends a transaction where "the sole business purpose of which may be tax avoidance and the tax treatment of which may be not supported in the Internal Revenue Code and related regulations."[72] In essence, both the registered public accounting firm and the audit committee should consider whether the proposed service qualifies as an allowable tax service or an impermissible "legal service" or "expert service."[73] Once again, however,

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69. *Id.* at 6017 n.103 (quoting Sarbanes-Oxley Act § 201(h) (to be codified at 15 U.S.C. 78j-1(h)).

70. *Id.* at 6017. In addition, the SEC's final rules specifically list fees billed for professional services for "tax compliance, tax planning, and tax advice" under the caption "Tax Fees." *Id.*; *see also infra* notes 160–61 and accompanying text.

71. Final Rules, *supra* note 12, at 6017.

72. *Id.*

73. The prohibition against "legal services" precludes an auditor from providing any service that only someone licensed, admitted, or otherwise qualified to practice law may provide in that jurisdiction. *See* 17 C.F.R. § 210.2–01(c)(4)(ix) (2003); *see also* Final Rules, *supra* note 12, at 6015. By comparison, the provision restricting "expert services unrelated to the audit" only applies to expert opinions or other expert services for an audit client or an audit client's legal representative if the auditor advocates the audit client's interest in litigation or in a regulatory or administrative proceeding or investigation. *See* 17 C.F.R. § 210.2–01(c)(4)(x); *see also* Final Rules, *supra* note 12, at 6015–16. The release accompanying the Final Rules specifically notes that the prohibition against expert services "does not apply to other permitted non-audit services, such as tax services." Final Rules, *supra* note 12, at 6016 n.97. Although almost all services that an accountant provides would arguably qualify as "expert services," the ban applies only to services that involve advocacy. As a result, the final regulation allows an auditor to provide factual accounts or testimony about work performed and to explain any positions taken or conclusions reached in any engagement for the audit client. *See* 17 C.F.R. § 210.2–01(c)(4)(x); *see also* Final Rules, *supra* note 12, at 6016.

recall that the SEC's rules do not apply to non-audit services that an auditing firm provides to a non-audit client.[74]

To enable investors to evaluate the auditor's independence, the final rules also expanded previously required disclosures regarding fees paid to the auditor for both audit and non-audit services to cover four distinct categories: "Audit Fees," "Audit-Related Fees," "Tax Fees," and "All Other Fees."[75] Under the caption "Tax Fees," a public company must disclose the aggregate amount that the auditor billed for professional services for "tax compliance, tax advice, and tax planning" in each of the last two fiscal years.[76] In addition, public companies must describe the nature of the services that gave rise to such fees and the amount of fees paid to the auditing firm for tax services.[77]

The SEC's new regulations on auditor independence also addressed compensation policies, conflicts of interest, and partner rotation. Going beyond the statutory language, the regulations specify that the receipt of compensation by an "audit partner" based upon procuring engagements with the audit client for services other than audit, review, and attest services destroys independence.[78] The SEC rules also require a one-year "cooling off" period prior to the commencement of audit procedures if certain members of an audit client's senior management have served as members of the audit team.[79] Finally, the rules generally require the rotation of the lead and concurring partners on an audit team every five years.[80]

As noted, SOx directed the SEC to prescribe rules requiring the national securities exchanges and national securities associations to adopt new listing standards regarding audit committees that comply with the audit committee requirements that SOx mandated.[81] In April 2003, the SEC issued rules that required each national securities exchange and national securities association

74. *See* Final Rules, *supra* note 12, at 6010.

75. 17 C.F.R. § 240.14a-101 (Item 9(e)(1)). Previous proxy disclosure rules required public companies to disclose the professional fees paid to the auditor for both audit and non-audit services during the most recent fiscal year in three categories, namely "Audit Fees," "Financial Systems Design and Implementation Fees," and "All Other Fees." Final Rules, *supra* note 12, at 6030 n.226.

76. *See, e.g.*, 17 C.F.R. § 240.14a-101 (Item 9(e)(3)); *see also* Final Rules, *supra* note 12, at 6030, 6048.

77. *See, e.g.*, 17 C.F.R. § 240.14a-101 (Item 9(e)(3)); *see also* Final Rules, *supra* note 12, at 6030, 6048.

78. *See* 17 C.F.R. § 210.2-01(c)(8); *see also* Final Rules, *supra* note 12, at 6024–26, 6047.

79. *See* 17 C.F.R. § 210.2–01(c)(2)(iii); *see also* Final Rules, *supra* note 12, at 6007–10, 6044–45.

80. *See* 17 C.F.R. § 210.2–01(c)(6); *see also* Final Rules, *supra* note 12, at 6017–22, 6047.

81. *See* Sarbanes-Oxley Act § 301 (to be codified at 15 U.S.C. § 78j-1).

to submit proposed amendments to their listing standards that comply with Exchange Act Rule 10A-3 by July 15, 2003.[82] In addition, the rules set December 1, 2003 as the deadline to obtain final approval.[83] Under the SEC's rules, most domestic companies must comply with the new listing rules by the earlier of (1) their first annual shareholders meeting after January 15, 2004, or (2) October 31, 2004.[84] On November 4, 2003, the SEC approved amended proposals from both the NYSE and the National Association of Securities Dealers, Inc., through its subsidiary, Nasdaq.[85]

In May 2003, the SEC promulgated a final rule, effective June 27, 2003, to implement another provision in SOx[86] that directed the SEC to prescribe rules or regulations to prohibit any officer or director of an issuer, or any other person acting under the direction of an officer or director, from taking any action to coerce, manipulate, mislead, or fraudulently influence the issuer's independent auditor for the purpose of rendering the financial statements materially misleading.[87] Among other things, the final rule prohibits various actions toward an independent auditor by any person acting under the direction of an officer or director if that person "knew or should have known that such action, if successful, could result in rendering the issuer's financial statements materially misleading."[88] Such conduct might include offering or paying bribes or other financial incentives, such as offering future employment or contracts for non-audit services; threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the issuer's accounting; and seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting.[89]

B. Other Developments

Enron's sudden collapse and the other recent financial scandals have seriously damaged the auditing profession's perceived independence and

82. *See* Standards Relating to Listed Company Audit Committees, 68 Fed. Reg. 18,788 (Apr. 16, 2003).

83. *See id.* at 18,788, 18,817.

84. *Id.* at 18,788.

85. *See* NYSE and NASD Rulemaking Relating to Corporate Governance, *supra* note 42.

86. *See* Sarbanes-Oxley Act § 303 (to be codified at 15 U.S.C. § 7242).

87. *See* Improper Influence on Conduct of Audits, 68 Fed. Reg. 31,820 (May 28, 2003) (to be codified at 17 C.F.R. § 240.13b2-2(b) (2003)).

88. *Id.* at 31,830 (to be codified at 17 C.F.R. § 240.13b2-2(b)(1)).

89. *See id.* at 31,823.

reputation.[90] Even after SOx's enactment, however, three more revelations have raised further questions about tax services and auditor independence. In early February 2003, *The Wall Street Journal* reported that Sprint Corp. (Sprint) ousted its two top executives because they purchased tax shelters that the company's auditor, Ernst & Young LLP (Ernst & Young), had marketed so that they could each avoid paying taxes on more than $100 million in gains from exercising stock options beginning in 1999.[91] When the IRS challenged the strategies, the executives faced tax bills that they could not afford to pay because their Sprint shares had plummeted in value.

Later that month, the Joint Committee on Taxation issued a 2,700-page report that concluded that Enron Corp. deliberately and repeatedly entered into complex transactions structured solely to obtain favorable tax and financial accounting treatments.[92] These transactions enabled Enron's tax department to become a "profit center," generating more than $2 billion in tax and financial accounting benefits.[93] In a dozen specifically described transactions, Enron obtained advice from various promoters and advisors, including its auditor, Arthur Andersen LLP (Andersen).[94] Andersen both promoted and provided the primary tax opinion letter in two transactions.[95] Other Big Four auditing firms or an affiliate assisted prominently in three other transactions.[96]

More recently, in January 2004, former U.S. Attorney General Richard Thornburgh, the examiner in the bankruptcy case involving WorldCom, Inc., issued a 542-page report that described as "'highly aggressive'" a tax strategy that the company's current auditor, KPMG LLP (KPMG), recommended to

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90. *See* Lingling Wei, *Enron Collapse Lets Academics Discuss Ethics*, WALL ST. J., Feb. 13, 2002, at B9 (citing a report from the American Institute of Certified Public Accountants that enrollment in accounting programs had dropped twenty-five percent in the previous four years). In early November 2003, a subsidiary of Charles Schwab Corp. released a survey that found that sixty-five percent of those polled do not trust independent auditors, up from fifty-eight percent in 2002. *See* Lynn Cowan, *Rich See More Risk Everywhere, but Stocks Offer Some Solace*, WALL ST. J., Nov. 6, 2003, at D3 (stating that the U.S. Trust Co. conducted the survey via telephone from mid-September to mid-October 2003).

91. *See* Rebecca Blumenstein et al., *Sprint Forced Out Top Executives over Questionable Tax Shelter*, WALL ST. J., Feb. 5, 2003, at A1; Rebecca Blumenstein & Carol Hymowitz, *Inside the Tough Call at Sprint: Fire Auditor or Top Executives?*, WALL ST. J., Feb. 10, 2003, at A1.

92. *See* STAFF OF THE JOINT COMM. ON TAXATION, REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS (2003), *available at* http://www.gpo.gov/congress/joint/jcs-3-03/vol1/index.html (last visited Mar. 25, 2004).

93. *See id.* at 8–9.

94. *See id.* at 8, 10, 16.

95. *See id.* at 10.

96. *See id.*

the company in an effort to avoid hundreds of millions of dollars in state income taxes.[97] Although Andersen audited WorldCom before its bankruptcy, the company hired KPMG as its auditor after Andersen's collapse.[98] Subsequently, Massachusetts and thirteen other states filed motions seeking to disqualify KPMG as the company's auditor and to disgorge all fees paid to the firm, arguing that as auditor KPMG would need to evaluate its own previous tax advice.[99]

Collectively, these developments refocused attention on the conflicts of interest that can arise when an auditor markets a tax shelter to an audit client or its executives, whether or not the IRS actually questions the transaction.[100] In the aftermath of these developments, the publicity accompanying the more recent travel billing scandal involving PricewaterhouseCoopers LLP (Pricewaterhouse), Ernst & Young, and KPMG has further tarnished the accounting industry's reputation.[101] These firms, and perhaps Deloitte & Touche LLP (Deloitte & Touche), allegedly obtained hundreds of millions of dollars in rebates on airline tickets and other travel costs incurred on client business over a ten-year period beginning in 1991, but did not pass the savings along to their clients, including the federal government.[102] In December 2003, Pricewaterhouse agreed to a settlement valued at $54.5 million to resolve a class action lawsuit filed in a Texarkana, Arkansas state court.[103]

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97. Dennis K. Berman et al., *MCI Examiner Criticizes KPMG on Tax Strategy*, WALL ST. J., Jan. 27, 2004, at A3 (quoting examiner's report by Richard Thornburgh on MCI/WorldCom chapter 11 bankruptcy); *see also* Steve Burkholder, *Final Report Says WorldCom Could Be Target, Can Sue KPMG, Citigroup, Andersen*, CORP. L. DAILY, Jan. 28, 2004.

98. *See id.*

99. *See* Jonathan Weil, *WorldCom Is Told It Must Withhold Pay to KPMG*, WALL ST. J., Mar. 22, 2004, at C5; Shawn Young & Jonathan Weil, *States Move to Oust KPMG As MCI's Independent Auditor*, WALL ST. J., Mar. 17, 2004, at A3.

100. *See* Cassell Bryan-Low, *More Ernst Nonaudit Services Under Fire*, WALL ST. J., Mar. 10, 2003, at C1.

101. *See* Jonathan Weil & Cassell Bryan-Low, *Audit Firms Overbilled Clients for Travel, Arkansas Suit Alleges*, WALL ST. J., Sept. 17, 2003, at A1; Jonathan Weil & Cassell Bryan-Low, *Arkansas Rulings May Hurt Reputation of Pricewaterhouse*, WALL ST. J., Sept. 18, 2003, at C1.

102. *See* Jonathan Weil & Cassell Bryan-Low, *Travel-Billing Probe Has Bigger Scope*, WALL ST. J., Sept. 26, 2003, at C1.

103. *See* Jonathan Weil, *Pricewaterhouse Settles Billing Case*, WALL ST. J., Dec. 22, 2003, at A3; *see also* Jonathan Weil, *Disputed Discounts: Court Files Offer Inside Look at Pricewaterhouse Billing Clash*, WALL ST. J., Jan. 5, 2004, at A1.

III. THE ROLE OF CONFLICTS OF INTEREST AND UNCONSCIOUS BIAS IN AUDIT FAILURES

A recent *Harvard Business Review* article entitled "Why Good Accountants Do Bad Audits" argues that unconsciously biased judgments, or as noted earlier, what legal scholars often refer to as cognitive bias,[104] rather than criminal collusion between auditors and management, often cause audit failures.[105] Two recent experiments, one with business students and the other with professional auditors, demonstrated that even the suggestion of a hypothetical relationship with a client distorts an auditor's judgments. As the audit failure at Enron vividly illustrates, long-standing relationships involving millions of dollars in ongoing revenues can only magnify the results. The article posits that three structural aspects of the accounting industry—ambiguity, attachment, and approval—create significant opportunities for bias to influence auditing judgments. In addition, the article highlights three aspects of human nature—familiarity, discounting, and escalation—that amplify auditors' unconscious biases.[106]

A. Ambiguity

Accounting remains an art, not a science, which requires enterprises and their auditors to exercise professional judgment in preparing and auditing financial statements. Although we often hear accountants referred to as "bean counters" and may believe that accounting provides clear-cut answers to all questions, financial accounting requires various estimates that affect the amounts shown in the financial statements, including the reported amounts of assets, liabilities, revenues and expenses. In addition, generally accepted accounting principles often allow alternative treatments for the same transaction or events and may not address a particular situation because business transactions evolve more rapidly than accounting principles. Witness the Internet's recent emergence and Enron's transformation from a regional natural gas company to a global energy and commodities trader.[107] Given the various accounting estimates and permissible choices in accounting methods, a typical business enterprise could potentially select from more than a million

104. *See supra* note 20.

105. *See* Bazerman et al., *supra* note 19, at 102.

106. *See id.*

107. *See generally* Matthew J. Barrett, *Enron, Accounting and Lawyers*, NOTRE DAME LAWYER, Summer 2002, at 14–15, *available at* http://www.nd.edu/~ndlaw/alumni/ndlawyer/barrett.pdf (last visited Mar. 25, 2004).

possible "bottom lines."[108] To illustrate, the fast-food chain Wendy's once advertised that its customers could order a hamburger 256 different ways. Wendy's offered eight different toppings and condiments, such as lettuce, tomato, cheese, ketchup, and mustard, which customers could request. Either selecting or omitting those individual extras translated to 256 options, a number that grew exponentially with each extra. For public companies today, generally accepted accounting principles allow even more choices. In this regard, entities must decide when to recognize revenue; estimate sales returns and allowances, warranty costs, useful lives, and salvage values; select inventory and depreciation methods; and decide whether or not to expense stock options. Bias thrives in such an environment.[109]

B. Attachment

The auditor's business interests in fostering a long-term relationship with a client's management encourage auditors to render "clean" audit opinions in an effort to retain any existing engagements and to secure future business. Auditors that issue anything but an unqualified opinion frequently get replaced.[110] During the late 1990s, the largest public accounting firms—first the Big Six and then the Big Five (now the Final Four)—increasingly provided non-audit services, such as consulting, internal auditing, and tax advising, often to the very enterprises they audited.[111] During 2000, Enron paid $52 million to Andersen—$25 million for auditing services, and an additional $27 million for non-auditing services,[112] including $3.5 million for tax work—and ranked as Andersen's second largest client.[113] Perhaps more significantly, an internal Andersen memo in February 2001 regarding the retention of Enron as an audit client refers to $100 million a year in potential

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108. *See* HERWITZ & BARRETT, *supra* note 6, at 173 (citing R.J. Chambers, *Financial Information and the Securities Market*, 1 ABACUS 3, 13–16 (1965), *reprinted in* R.J. CHAMBERS, ACCOUNTING FINANCE AND MANAGEMENT, 185–88 (1969)).

109. *See* Bazerman et al., *supra* note 19, at 98–99.

110. *See id.* at 99.

111. *See supra* notes 30–34 and accompanying text.

112. *See* ENRON CORP., SCHEDULE 14A (2001), *available at* http://www.sec.gov/Archives/edgar/data/1024401/000095012901001669/0000950129-01-001669.txt (last visited Mar. 15, 2004); *see also* Barrett, *supra* note 107, at 16.

113. *See The Enron Collapse: Impact on Investors and Financial Markets: Joint Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Emters. and the Subcomm. on Oversight and Investigations of the Comm. on Fin. Servs.*, 107th Cong. 47, 113 (2001) (statement of Joseph F. Berardino, Managing Partner – Chief Executive Officer, Andersen) [hereinafter Berardino testimony] (detailing non-audit fees that Enron paid to Andersen in 2001).

revenues from Enron.[114] Even if Andersen could absorb the loss of Enron as a client, individual careers and the Houston office depended upon retaining the Enron engagement. As the audit partner for the firm's second largest client, David B. Duncan enjoyed clout not only in the Houston office, but throughout Andersen.[115] Indeed, one accountant has accurately described a \$50 million client as a "meal ticket" for a forty-two year-old audit partner.[116]

Large professional services or accounting firms typically encourage their employees, especially those not likely to become partners, to take jobs with clients or potential clients when they leave the firm. The resulting "revolving door" between Andersen and Enron only enhanced the financial attachment. From 1989-2001, eighty-six people left Andersen to work for Enron.[117] Andersen alumni at Enron included Richard A. Causey, its chief accounting officer and a former Andersen audit manager; Jeff McMahon, Enron's treasurer; and Sherron Smith Watkins, the vice president who unsuccessfully tried to blow the whistle on Enron's aggressive accounting.[118] Employees at Enron often referred to Andersen as "Enron Prep."[119] In the "up or out" environment at Andersen, everyone who worked on the Enron account had subtle incentives to keep both their bosses and the people at Enron happy.

The so-called "integrated audit" that Andersen employed at Enron and sought to market more widely to other clients also documents attachment. Under this model, Andersen sought to combine its role as external auditor with internal auditing, the process whereby an enterprise checks its own books.[120] Paralleling and sometimes overlapping outside or independent audits, internal audits seek to ensure that an enterprise follows its procedures, safeguards its assets, and operates efficiently.[121] Under a five-year, \$18 million contract that sought to create an "integrated audit," Andersen took

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114. *See* Tom Hamburger & Ken Brown, *Andersen Knew of Enron Woes a Year Ago*, WALL ST. J., Jan. 17, 2002, at A3.

115. *See* Flynn McRoberts et al., *A Final Accounting: Ties to Enron Blinded Andersen*, CHI. TRIB., Sept. 3, 2002, at 1.

116. *See* Dellinger, *supra* note *, at 155 n.2.

117. *See* Peter Behr & April Witt, *Concerns Grow Amid Conflicts*, WASH. POST, July 30, 2002, at A1.

118. *See* ENRON AND BEYOND: TECHNICAL ANALYSIS OF ACCOUNTING, CORPORATE GOVERNANCE, AND SECURITIES ISSUES 156 (Julia K. Brazelton & Janice L. Ammon eds., 2002) [hereinafter ENRON AND BEYOND]; John R. Wilke et al., *U.S. Will Argue Andersen Knew of Missteps*, WALL. ST. J., May 7, 2002, at C1; Alexei Barrionuevo & Jonathan Weil, *Duncan Knew Enron Papers Would Be Lost*, WALL. ST. J., May 14, 2002, at C1.

119. *See* Behr & Witt, *supra* note 117.

120. *See* Alexei Barrionuevo & Jonathan Weil, *Partner Warned Arthur Andersen on Enron Audit*, WALL ST. J., May 9, 2002, at C1; Barrionuevo & Weil, *supra* note 118 ("Andersen held out Enron as the prime example of its 'integrated' audit approach.").

121. *See* HERWITZ & BARRETT, *supra* note 6, at 202–04.

over Enron's internal auditing in 1994, transforming dozens of Enron staffers into Andersen employees.[122] *The Wall Street Journal* reported that before Enron's collapse, more than 100 Andersen employees worked in leased space inside Enron's headquarters in Houston.[123] In videotapes that Andersen filmed to market the "integrated audit," people at both Andersen and Enron described how intertwined their operations had become. In one segment, Jeffrey Skilling, then Enron's president, commented: "I think over time we and Arthur Andersen will probably mesh our systems and processes even more so that they are more seamless between the two organizations."[124] Coupled with the inherent ambiguity in financial statements, such attachment can influence auditors to accept the "client's" interpretation and application of generally accepted accounting principles.[125]

C. Approval

Management has historically selected the accounting principles and estimates that an enterprise uses to prepare its financial statements.[126] An audit essentially endorses or rejects the accounting choices that the client's management has made.[127] Research has shown that self-serving biases become even stronger when people are endorsing someone else's judgments, provided those judgments align with their own biases, than when they are asked to make original judgments themselves.[128] This research suggests that unconscious bias can cause auditors to accept more aggressive accounting treatments than the auditor might propose independently.[129]

D. Familiarity

People are less willing to harm individuals they know relative to strangers they have never met. People are even less willing to harm paying clients, or individuals they consider paying clients, with whom they enjoy ongoing relationships.[130] Like lawyers for corporations, those who represent

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122. *See* McRoberts et al., *supra* note 115; Alexei Barrionuevo, *Court Documents Show Andersen's Ties with Enron Were Growing in Early '90s*, WALL ST. J., Feb. 26, 2002, at A6.

123. *See* Ianthe Jeanne Dugan et al., *On Camera, People at Andersen, Enron Tell How Close They Were*, WALL ST. J., Apr. 15, 2002, at A1.

124. *Id.*

125. *See* Bazerman et al., *supra* note 19, at 99–100.

126. *See* HERWITZ & BARRETT, *supra* note 6, at 173.

127. *See* Bazerman et al., *supra* note 19, at 99–100.

128. *See id.* at 99.

129. *See id.* at 99–100.

130. *See id.* at 100.

the entity and not the officer who hired them, auditors' real responsibilities flow to the investing public, not the manager or individual who retained them.[131] An auditor who suspects errors or misstatements, whether intentional or not, must choose, perhaps unconsciously, between harming a known individual and likely the auditor's own self-interest by questioning the accounting, or injuring faceless others by failing to object to the possibly incorrect numbers. Such biases only grow stronger as personal relationships with the client's management, sometimes former auditing colleagues, deepen.[132] David Duncan and Rick Causey often vacationed together, annually leading a group of Andersen and Enron "co-workers" on golfing trips to elite courses around the country.[133] The "revolving door" between Andersen and Enron and the "integrated audit" model also strengthened the familiarity.[134] Such familiarity, and the accompanying trust which often arises, can erode an auditor's objectivity and neutrality, thereby increasing the chances that the auditor will believe an untrue assertion from the client's management.[135]

E. Discounting

Immediate consequences influence behavior more than delayed ones, especially when uncertainty accompanies the future costs. This tendency appeals to the propensity to place more emphasis on the short-term effect of decisions than their long-term ramifications. Immediate adverse consequences, including damage to the relationships with the client and its management, possible loss of the engagement, and potential unemployment, may dissuade auditors from issuing anything other than an unqualified opinion. By comparison, the costs arising from an audit failure, namely civil lawsuits, disciplinary proceedings, and reputational losses, appear distant and uncertain, or even unlikely.[136] After an earlier audit failure at Waste Management, for which Andersen agreed to the largest fine ever against an auditor, the firm did not fire the audit partners whom the SEC sanctioned.[137] Ironically, one of those auditors wrote the document retention policy featured in Andersen's criminal trial for obstructing justice in the Enron

131. *See* HERWITZ & BARRETT, *supra* note 6, at 182–83.

132. *See* Bazerman et al., *supra* note 19, at 100.

133. *See* McRoberts et al., *supra* note 115.

134. *See supra* notes 117–23 and accompanying text.

135. *See* Bazerman et al., *supra* note 19, at 100.

136. *See id.*

137. Flynn McRoberts et al., *A Final Accounting: Civil War Splits Andersen*, CHI. TRIB., Sept. 2, 2002, at 1.

investigation.[138] The internal Andersen memo regarding the decision to retain Enron as a client documents Enron's aggressive accounting practices and potential conflicts of interest by then-Enron chief financial officer Andrew Fastow.[139] Nevertheless, Andersen executives decided to retain Enron as a client because the auditing firm "had the appropriate people and processes in place to serve Enron and manage [the firm's] engagement risks."[140] As total audit and other fees from Enron grew to $52 million in 2000, Andersen willingly assumed increasing engagement risks for a client that the firm believed could potentially generate $100 million in revenues annually.[141]

F. Escalation

People often hide or explain away minor mistakes, often without realizing what they are doing. Unconscious biases may cause an auditor to accept small imperfections in a client's financial statements.[142] Over time, such misstatements can become material. At that point, correcting the situation may require admitting previous errors or biases, restating the financial statements, or even resigning. Rather than take those actions, the auditor may try to conceal the problem, thereby escalating unconscious bias into fraud.[143] For example, after Andersen approved the non-consolidated accounting for various special purpose entities, the auditors later adopted an interpretation that enabled Enron to avoid recognizing losses for declines in the value of underlying investments in certain entities known as the Raptors.[144] At Andersen's criminal trial, prosecutors also introduced evidence to show that the firm's prior audit failures at Waste Management and Sunbeam gave Andersen a motive to hide the problems at Enron.[145]

IV. TAX SERVICES AND CONFLICTS OF INTEREST

To the extent that conflicts of interest cause audit failures, SOx addresses those problems for publicly traded enterprises subject to the SEC's jurisdiction with one significant exception: an auditor's potential desire to

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138. *See id.*
139. *See* Hamburger & Brown, *supra* note 114.
140. *Id.*
141. *See id.*
142. *See* Bazerman et al., *supra* note 19, at 100.
143. *See id.*
144. *See* Jonathan Weil, *Enron's Auditors Debated Partnership Losses*, WALL ST. J., Apr. 3, 2002, at C1.
145. *See* Barrionuevo & Weil, *supra* note 120.

obtain or retain non-audit fees arising from tax engagements might, whether consciously or unconsciously, influence the auditor's decision to acquiesce in, or at least not object to, a questionable accounting practice.[146] As noted, Enron paid Andersen $3.5 million for tax services in 2000.[147] Even though management can no longer hire or fire the auditor, management can potentially use "enhanced independence" as a pretext to support a recommendation that the audit committee hire another firm to provide tax services. When an auditor questions a particular accounting treatment or disclosure that management prefers, management can subtly hint at the possibility of such a recommendation, which would obviously jeopardize potentially significant tax or other permissible consulting fees, unless the auditor accepts the preferred treatment or disclosure.[148] Any such scenario gives management undesirable leverage over the auditor.

Even in a post-SOx world, auditors continue to collect large fees for providing tax services to audit clients. *The Wall Street Journal* has reported that during 2002, General Electric Co. paid its auditor, KPMG, more than $21 million in tax fees.[149] Offering another example, the same article points out that Caterpillar Inc. paid its auditor, Pricewaterhouse, $17.4 million for tax work in 2002,[150] more than twice the $8.2 million that the company paid in

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146. SOx largely misses the mark, however, if unconscious bias explains more than a few audit failures. As long as financial or other incentives tempt auditing firms and their executives and employees to try to retain or earn another engagement from the audit client, whether the future engagement relates to a subsequent audit, an assignment to provide tax services, or the opportunity to provide other nonprohibited services, unconscious bias can remain present in audits. Thus, unconscious bias also suggests that mandatory rotation of audit firms, after fixed terms for predetermined fees, might minimize the threat that a public company can fire or otherwise punish an auditor for failing to approve questionable accounting practices. *See supra* note 21.

147. *See* Berardino testimony, *supra* note 113.

148. *See generally* HERWITZ & BARRETT, *supra* note 6, at 173–74, 192–93. To some extent, the SEC's new rules against improper influence on the conduct of an audit deter such behavior. *See supra* notes 86–89 and accompanying text. Unfortunately, the intent requirement, however minimal, renders those new rules unlikely to prevent misbehavior. At least as to the words "coerce, manipulate, or mislead," the SEC's rules seek to impose a negligence standard. *See* Improper Influence on Conduct of Audits, *supra* note 87, at 31,823. By using "knew or should have known," which the SEC admits has historically indicated a negligence standard, *see id.* at 31,826, the rule arguably ignores the clause "for the purpose of rendering such financial statements materially misleading" in SOx section 303(a). *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 303(a), 116 Stat. 745, 778 (to be codified at 15 U.S.C. § 7242). Devious and very careful or zealously represented management may well circumvent these rules.

149. *See* Cassell Bryan-Low, *Keeping the Accountants from Flying High*, WALL ST. J., May 6, 2003, at C1.

150. *See id.*

audit fees.[151] The amount for tax work included $13.9 million "'for services performed as a subcontractor for outside legal counsel.'"[152] For 2003, a spokeswoman at Caterpillar estimated that the amount for tax work would fall to $13.5 million.[153] During Hewlett-Packard Co.'s 2003 fiscal year, its auditor, Ernst & Young, provided $20.6 million in tax services.[154] As additional examples, Coca-Cola Co. and Citigroup Inc. paid their auditors $9.9 million and $8.5 million in tax fees, respectively, during 2003.[155] Given this potential conflict of interest, the following section will discuss some arguments why auditors for public companies should not offer various tax services.

A. Arguments Why Auditors for Public Companies Should Not Offer Various Tax Services to Audit Clients

To try to eliminate the potential conflicts of interest that arise when an auditor seeks to obtain or retain tax engagements with an audit client and to embrace more fully the three basic principles regarding auditor independence that Congress affirmed in SOx,[156] this article endorses the recommendation that auditors for public companies should focus exclusively on auditing.[157] Under that recommendation, registered public accounting firms should neither render any tax services to publicly traded audit clients or their executives nor promote tax shelters to anyone.[158]

Auditors have historically provided various tax services to audit clients, ranging from preparing tax returns, representing clients in tax audits and claims for refunds, advising clients how to structure regular business transactions to minimize taxes, and, more recently, recommending

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151. *See* Cassell Bryan-Low, *Accounting Firms Earn More from Consulting*, WALL ST. J., Apr. 16, 2003, at C9.

152. *Id.* (quoting regulatory filings of Caterpillar Inc.).

153. *See* Bryan-Low, *supra* note 149.

154. *See* David Bank, *Calpers Won't Back 5 Directors of H-P in Protest over Auditing*, WALL ST. J., Mar. 11, 2004, at A2.

155. *See* Alison Carpenter & Joyce E. Cutler, *CalPERS Continues to Draw Bright Line Looking at Auditor, Director Independence*, CORP. L. DAILY (BNA), Apr. 20, 2004.

156. *See supra* note 47 and accompanying text.

157. *See* Wolfman, *Stick to Your Auditing*, *supra* note 16.

158. *See, e.g.*, Wolfman, *The Best Way*, *supra* note 16 (arguing that any tax advice that an auditor provides to any client may impair the auditor's independence).

transactions solely to reduce taxes.[159] Adopting the rather arbitrary labels that the SEC used in the final regulations on auditor independence, this discussion divides "tax services" into three broad categories: "tax compliance," "tax planning and advice," and "tax shelters."[160] Within compliance work, an auditor might prepare tax returns, amended returns, or claims for refund, or provide tax payment-planning services.[161] The "planning and advice" category encompasses requests for private letter rulings or technical advice, merger and acquisition planning, employee benefit plans, and tax audits and appeals.[162] Under the category "tax shelter," the auditor might develop, market, or promote so-called "tax products," "tax minimization strategies," or "tax-motivated transactions," all of which "might satisfy the technical requirements of the tax statutes and administrative rules, but that serve little or no purpose other than to generate income tax or financial statements benefits."[163] These tax products often allow "value-added" billing or generate fees based on a percentage of the taxes saved.[164] Although various tax services present potential conflicts of interest in differing degrees, drawing lines between different types of tax services, such as tax compliance, tax planning and consulting, and tax shelters, presents very significant practical difficulties. Equally important remains the fact that even tax services that appear routine may impair auditor independence. Given the conflicts of interest and definitional problems, this part recommends that auditors for public companies neither provide tax services to audit clients or their executives nor promote tax shelters.

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159. Auditors originally examined the financial statements in an effort to provide assurance that those statements fairly presented the enterprise's financial condition and operating results. Given the connections between income for financial accounting purposes, usually referred to as "book income," and taxable income, accounting firms soon began preparing, or helping to prepare, tax returns for their audit clients. As accounting firms became proficient in tax matters, they began advising existing clients, and then potential clients, about ways to save taxes. Prior to SOx, one industry observer commented that "accounting firms sell tax products the same way 'Amazon.com sells books.'" Stratton, *supra* note 7.

160. Final Rules, *supra* note 12, at 6031. The Final Rules borrowed language from The Conference Board Commission on Public Trust and Private Enterprise to describe "tax shelters" as "'novel and debatable tax strategies and products' . . . the sole business purpose of which may be tax avoidance and the tax treatment of which may be not supported in the Internal Revenue Code and related regulations." *Id.* at 6017 & n.112.

161. *See id.* at 6031. This category may encompass more than so-called traditional tax preparation services, which arguably includes only tax return preparation and, perhaps, tax refund claims arising from another tax audit.

162. *See id.*

163. STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 92, at 17.

164. *See* Stratton, *supra* note 7.

1. *The Inherent Conflicts of Interest*

In an effort to illustrate the inherent conflicts of interest that can arise when auditors provide various tax services, this section separately discusses the three different types of tax services that the SEC's final rules address: tax compliance services, tax planning and consulting, and "tax shelters." From the outset, we should acknowledge the significant difficulty in distinguishing between those three categories of tax services. Do tax compliance services include representing a client in any administrative proceeding that may arise when a governmental body audits a tax return that the auditor may have prepared? Is preparing an amended tax return always compliance-related? At exactly what point does conventional tax planning begin and end? Because the SEC has cautioned audit committees about "tax shelters," this part begins with those services, and then proceeds to discuss tax planning and consulting services.

Recall that the basic principles underlying the auditor independence rules in SOx generally dictate that (1) an auditor cannot function as part of management; (2) an auditor cannot audit his or her own work; and (3) an auditor cannot serve as an advocate for the client.[165] Although many commentators view tax compliance services as perfectly acceptable for auditors to provide to audit clients, this part suggests that, in the context of a public company, applying those basic principles demonstrates that inherent conflicts of interest even flow from compliance services. As a result, auditors should neither provide tax services, whether preparation, planning, or minimization services, to publicly traded audit clients and their executives nor promote any tax shelters.

a. Tax Shelters

Keep in mind that although the SEC did not use the label "tax shelters" to describe certain tax services that the business community refers to as "tax products," "tax minimization strategies,"or "tax-motivated transactions," the SEC's release accompanying its final rules on auditor independence did encourage audit committees to "scrutinize carefully" any engagement in which the auditor initially recommends a transaction where "the sole business purpose of which may be tax avoidance and the tax treatment of which may be not supported in the Internal Revenue Code and related regulations."[166] In discussing tax shelters, also recall that the SEC's rules do not apply to non-

165. *See supra* note 47 and accompanying text.

166. Final Rules, *supra* note 12, at 6017.

audit services that an auditing firm provides to a non-audit client.[167] In other words, the SEC rules do not prohibit registered public accounting firms from offering tax services to non-audit clients.

At the most fundamental level, designing and marketing tax shelters that exploit existing "loopholes" in tax laws usually involve advocacy and partiality, rather than the independence that best protects the investing public.[168] Only a truly independent auditor can provide adequate assurance to the investing public about the appropriateness of an enterprise's tax reserves and related disclosures.[169]

In addition, when a registered public accounting firm promotes a tax shelter to an audit client, the auditor often must audit its own advice. In an audit, the auditor evaluates the various representations that an enterprise's management asserts in the financial statements and related notes about the firm's assets and liabilities at a specific date and transactions during a particular accounting period so that the auditor can render a report on, and almost always express an opinion about, those financial statements and accompanying disclosures.[170] Ultimately, the auditor seeks to express an opinion as to whether the financial statements and related disclosures present fairly, in all material respects, the enterprise's financial condition, results of operations, and cash flows in conformity with generally accepted accounting principles.[171]

When auditors review the items for accrued taxes payable on the balance sheet and income tax expense on the income statement, they must come to conclusions about the validity of these amounts before they can express an opinion as to whether the financial statements fairly present the enterprise's financial condition and operating results in accordance with generally accepted accounting principles.[172] As a result, auditors must examine the enterprise's tax returns and assess the so-called "tax reserves" or "tax

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167. *See id.*

168. *See* Stratton, *supra* note 7.

169. *See* Matthew J. Barrett, *Opportunities for Obtaining and Using Litigation Reserves and Disclosures*, 63 OHIO ST. L.J. 1017 (2002) (discussing litigation reserves and disclosures generally).

170. *See generally* HERWITZ & BARRETT, *supra* note 6, at 180–82, 200–04, 215–17, 233–40. In rare situations, the auditor must disclaim any opinion when the circumstances have prevented the auditor from performing an examination sufficient in scope to enable the auditor to form an opinion on the financial statements. *See id.* at 239–40.

171. *See generally id.* at 216–17, 233–36.

172. *See* Stratton, *supra* note 7. Auditors must perform these procedures whether other professionals within the firm prepared the tax returns or offered any tax advice, whether the audit client prepared the returns itself, or whether another law or accounting firm prepared the return or offered any tax advice. *See id.*

provisions"[173] to evaluate income tax expense for the current period and to determine whether any material unrecorded or undisclosed tax liabilities exist. For this reason, all auditing firms need tax expertise to assess both the enterprise's tax reporting positions and any necessary tax reserves or provisions.[174]

Because income taxes can amount to approximately one-half of a public company's net income,[175] an auditor would almost always consider the amount for any period's income tax expense as material to the financial statements.[176] In addition, an unrecorded or undisclosed tax liability could preclude the financial statements from fairly presenting the enterprise's financial condition, results of operations, and cash flows in conformity with generally accepted accounting principles in all material respects.[177]

In most tax shelters, the promoter either issues a tax opinion or secures an opinion from another tax professional that the promoter, at least implicitly, believes supports the desired tax treatment. Anytime an auditor sells a tax shelter to an audit client that materially affects the client's income tax expense or liabilities for income taxes payable (a "material tax shelter"), the auditing firm must review that opinion, whether actually rendered or implicitly endorsed, while determining if the client has established adequate tax reserves. As a result, selling or promoting a material tax shelter to an audit client forces the auditor to audit its own advice. Any tax shelter directly affects items on the financial statements, such as income taxes payable,

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173. Accountants use the terms "reserve" and "provision" to refer to anticipated liabilities when uncertainty exists about the existence, amount, or timing of the underlying obligation. Accordingly, "tax reserves" or "tax provisions" refer to amounts believed necessary to satisfy unpaid tax liabilities, whether or not the taxing authority has begun efforts to collect the tax. *See* Barrett, *supra* note 169, at 1019 n.4.

174. *See* Stratton, *supra* note 7.

175. Section 11 of the Internal Revenue Code of 1986, as amended, imposes a thirty-five percent effective tax rate on the most profitable corporations. *See* I.R.C. § 11(b)(1)(D) (2000). In addition, these corporations often must also pay various foreign, state, and local income taxes. A thirty-five percent tax rate would leave sixty-five cents in after-tax income for each dollar of income before taxes. In his most recent letter to the shareholders of Berkshire Hathaway Inc., Warren Buffet, however, observed that "Today, many large corporations . . . pay nothing close to the stated federal tax rate of 35%." Letter from Warren E. Buffet, Chairman of the Board, to the Shareholders of Berkshire Hathaway Inc. 7 (Feb. 27, 2004), *available at* http://www.berkshirehathaway.com/letters/2003ltr.pdf (last visited May 12, 2004).

176. As a general rule, auditors usually consider any item that exceeds ten percent of income before taxes as material. *See* HERWITZ & BARRETT, *supra* note 6, at 228 (citing LuAnn Bean & Deborah W. Thomas, *The Development of the Judicial Definition of Materiality*, 17 ACCT. HISTORIANS J. 113 (1990)).

177. *See, e.g.*, Endo v. Albertine, 863 F. Supp. 708 (N.D. Ill. 1994) (class action arising from alleged failure to disclose material facts regarding contingent tax deficiencies).

income tax expense, net income, and earnings per share. When an auditing firm that has promoted a material tax shelter to the audit client examines the tax reserves, both cognitive bias and common sense suggest that the members of the audit team will act less skeptically than an auditor unaffiliated with anyone who has promoted the tax shelter.[178] Moreover, if the tax practice group in a registered public accounting firm has recommended, or wants to recommend, that an audit client take an aggressive position, whether via a tax shelter or otherwise, the tax professionals might lobby their audit colleagues in an effort to preserve favorable financial reporting treatment and to avoid any disclosure about the possible tax ramifications in the financial statements and related notes.[179]

Moreover, if the IRS or another taxing authority questions the reporting position, the resulting tax audit ("examination") may require the auditing firm to advocate for the client.[180] The release accompanying the SEC's final rules on auditor independence affirmatively states that "representing an audit client before a tax court, district court, or federal court of claims" impairs independence.[181] Similarly, representing an audit client during administrative proceedings arising from a tax audit should also impair auditor independence. While confidentiality rules would typically prevent the general public from learning that the auditing firm represented the audit client in such administrative tax proceedings, the fact remains that those administrative proceedings would require the auditing firm to advocate for the client. Such advocacy directly contradicts the basic principles that informed the list of prohibited activities that Congress established.

A different kind of conflict can arise when the auditor offers a tax shelter or provides a tax opinion to management. This conflict also requires the auditor to advocate for management. Recall that Sprint's auditor, Ernst & Young, provided financial-planning advice to various corporate executives, recommended tax strategies to the company's two highest ranking executives so that they could avoid paying taxes on more than $100 million in stock options, and prepared their tax returns.[182] When the IRS began to audit those

178. *See* Stratton, *supra* note 7.

179. Because disclosures in the financial statements or related notes can alert tax authorities about tax reserves or aggressive tax positions, tax practitioners might lobby auditors against any accounting treatment or disclosures, whether in the financial statements or in the tax return itself, that might undercut any strategy designed to reduce taxes. *See generally* Barrett, *supra* note 169; *see also* Stratton, *supra* note 7.

180. *See* Brent Goldwyn, *Goelzer Urges Corporations to Avoid Tax Shelters Marketed by Their Auditors*, CORP. L. DAILY (BNA), Mar. 26, 2003.

181. Final Rules, *supra* note 12, at 6017.

182. *See* Cassell Bryan-Low & Rebecca Blumenstein, *How Ernst Gave Shelter to Many*, WALL ST. J., July 8, 2003, at C1.

returns, an obvious conflict of interest arose because the examination required Ernst & Young to advocate for management, while at the same time acting as a "watchdog of management" for the investing public.[183] If a public company believes that it should offer tax services as an executive benefit, the company should retain someone other than the auditor to provide those services.[184]

Because accounting firms tend to sell similar tax-shelters, even the attempt to sell a tax strategy to a non-audit client can impair independence.[185] Once again, unconscious bias and common sense suggest that the members of an audit team will find it difficult to question a tax shelter substantially similar to a tax product that their firm has promoted to non-audit clients.[186] For these reasons, registered public accounting firms should not promote tax shelters to anyone.

b. Tax Advice and Planning

Tax advice and planning, whether offered by tax professionals in registered public accounting firms or elsewhere, can take numerous forms. Ultimately, any such tax consulting seeks to increase the client's bottom line. According to the SEC, the "planning and advice" category encompasses requests for private letter rulings or technical advice, merger and acquisition planning, employee benefit plans, and tax examinations and appeals.[187] The release accompanying the SEC's final rules on auditor independence, however, unequivocally stated that "representing an audit client before a tax court, district court, or federal court of claims"[188] would impair independence. As a result, tax professionals from a registered public accounting firm cannot lawfully represent a publicly traded audit client in tax litigation.[189] Both before SOx and after the SEC's final rules, an audit client could conceivably ask someone from its auditing firm to provide expert testimony in such tax

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183. *Id.*

184. *See* Goldwyn, *supra* note 180.

185. *See* Bryan-Low & Blumenstein, *supra* note 182 (reporting that Pricewaterhouse, KPMG, and Andersen also widely marketed tax shelters similar to the strategies that Ernst & Young sold to executives at Sprint Corp.); *see also supra* notes 97–99 and accompanying text (describing how KPMG's new audit engagement at WorldCom requires the auditor to evaluate a tax strategy that it sold to the company before accepting the audit engagement).

186. *See, e.g.*, Wolfman, *Auditor Independence Rules*, *supra* note 16 (suggesting an amendment to SOx that would prohibit an auditor from performing non-audit services to anyone).

187. *See* Final Rules, *supra* note 12, at 6031.

188. *Id.* at 6017.

189. *See id.*

litigation.[190] In addition, tax professionals in accounting firms presumably can monitor Congress, the Treasury Department, and the IRS, as well as the equivalent state, local, and foreign bodies, for legislative and administrative developments and presumably may engage in lobbying efforts on behalf of audit clients.[191]

Similar to engagements involving tax shelters, the activities in the SEC's category of tax advice and planning sometimes require tax professionals and their firms to give the client an "opinion" setting forth the expected tax consequences. At other times, the firm may transmit such advice via a less formal memorandum, or even orally. In any event, generally accepted auditing standards require the auditor to evaluate the amounts for accrued income taxes payable and income tax expense before expressing an opinion on the financial statements.[192] Whenever an auditing firm conveys a tax opinion in a material tax engagement ("material tax engagement") to a public company, the auditor must review its own work, thereby violating one of the basic principles that Congress recognized as underlying auditor independence. Surprisingly, however, the SEC's final rules "do not prohibit an accounting firm from providing [appraisal or valuation] services for non-financial reporting (e.g., transfer pricing studies, cost segregation studies, and other tax-only valuations) purposes."[193] Notably, the resulting transfer prices and tax valuations affect the amounts that enterprises must pay as income taxes, record as income tax expense, and reflect in tax reserves on their books. Consequently, whenever tax professionals in a registered public accounting firm undertake to provide material tax planning advice to an audit client, the audit requires the firm to audit its own work.[194]

By comparison, providing a tax opinion to a third party as a condition to closing a transaction, such as a merger or acquisition, places the auditor in the position of advocating on behalf of the audit client.[195] Whenever the auditor provides a tax opinion to a corporate executive of the audit client, the same

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190. *See* Sheryl Stratton, *Outlook for Tax Services Uncertain After Sarbanes-Oxley*, 97 TAX NOTES 171 (2002). After SOx, the prohibition against auditors providing "expert services" prevents an auditor from assisting a client's legal representative or advocating on behalf of an audit client in litigation and regulatory or administrative investigations or proceedings. *See* Final Rules, *supra* note 12, at 6016. For reasons not well explained, however, this prohibition "does not apply to other permitted non-audit services, such as tax services." *Id.* at 6016 n.97.

191. *See* Stratton, *supra* note 190.

192. *See supra* notes 170–74 and accompanying text.

193. Final Rules, *supra* note 12, at 6012.

194. If the IRS or another governmental body audits the client's tax returns, the tax opinion puts the auditor in the position of advocating for the audit client, regardless of whether the auditor signed the tax return.

195. *See supra* note 180 and accompanying text.

conflict of interest described in the previous section on tax shelters arises if the IRS audits the executive's return. Such a scenario requires the auditor to advocate for the executive, while at the same time acting as a "watchdog of management" for the investing public.[196]

Sometimes a client may ask a tax professional to seek a ruling or technical advice from the governmental body administering a particular tax or to submit a claim for refund in any situation where the governmental body could potentially deny the claim. When a tax professional in a registered public accounting firm accepts such an engagement from an audit client, the auditing firm becomes an advocate before the administrative body.

As mentioned at the beginning of this section, the release accompanying the SEC's final rules on auditor independence certainly implies that tax professionals in registered public accounting firms may represent publicly traded audit clients in tax examinations or administrative proceedings arising from examinations or contested claims for refund. While such examinations and administrative proceedings typically require the taxpayer's representative to respond to factual inquiries and requests for relevant documents and to supply reconciliations, such matters usually also require the representative to provide explanations for the taxpayer's position. As such, an audit resembles an adversarial situation. Unless the client and the tax authority agree to resolve the matter, the representative usually must respond to any proposed adjustments or to any issues that the examiner might have raised. During this process, the representative often prepares a memorandum that supports the taxpayer's position, participates in meetings and conferences, and negotiates a resolution of the issues. Such activities require a tax professional in a registered public accounting firm to serve as an advocate.

Although the SEC's final regulations on auditor independence seemingly allow registered public accounting firms to offer tax advice and planning, including requests for private letter rulings or technical advice, merger and acquisition planning, employee benefit plans, and tax examinations and appeals, such activities may require an auditing firm to review its own work and often demand the auditor to serve as an advocate for the audit client or its management. As another "bright line" best practice, a registered public accounting firms should not provide tax planning and advice to publicly traded audit clients. In an effort to avoid the need to audit its own work, a registered public accounting firm, at a minimum, should not issue a tax opinion to a publicly traded audit client in any transaction presenting a tax issue that could materially affect the client's financial statements. To avoid serving as an advocate for a publicly traded audit client or its management, a registered

196. *See* Bryan-Low & Blumenstein, *supra* note 182.

public accounting firm should *not*: provide an opinion to a third party on behalf of an audit client; submit a request for a tax ruling, participate in administrative proceedings arising from examinations or contested claims for refund, or lobby on behalf of an audit client; or render any tax advice to an executive of an audit client.

c. Tax Compliance

The SEC construes "tax compliance" as generally involving the preparation of original and amended tax returns, claims for refund, and tax payment-planning services.[197] With the exception of tax payment-planning services, the other forms of tax compliance work create at least potential conflicts of interest. Recall that before an auditor can express an opinion as to whether the financial statements fairly present the enterprise's financial condition and operating results in accordance with generally accepted accounting principles, the auditor must examine, if material, the amounts for income taxes payable on the balance sheet and income tax expense on the income statement and come to conclusions about any amounts reported. In addition, the auditor must determine whether any material unrecorded or undisclosed tax liabilities exist. Collectively, these tasks require the auditor to review the enterprise's tax returns. If a registered public accounting firm has prepared the tax returns for an audit client, these procedures require the auditing firm to examine its own work.[198]

Even though the Internal Revenue Code provides considerable detail, many "gray areas" exist in federal income tax law. Tax return preparers, especially for public companies, often must explain their work during tax examinations or other administrative proceedings. As discussed in the previous section on tax advice and planning, such examinations and the related administrative proceedings typically require the return preparer to advocate on the client's behalf.[199] Once again, such advocacy directly contradicts the basic principles that informed the list of prohibited activities

197. *See* Final Rules, *supra* note 12, at 6031.

198. Tax return preparers presumably understand the relative aggressiveness of the various positions that the return takes. When the same firm audits the financial statements, common sense suggests that the auditor will accord considerable deference to a colleague's assessments.

199. *See* Alison Carpenter, *Oversight Board's Goelzer Urges Auditors To Be Cautious in Providing Tax Services*, CORP. L. DAILY (BNA), Sept. 16, 2003 (commenting in the context of tax shelters).

established by Congress.[200] Similarly, amended tax returns and claims for refund often require the auditor to advocate on behalf of the client.

2. *The Integrity of Auditing*

In addition to avoiding conflicts of interest, a restriction on tax services could help restore, or at least preserve, the auditing profession's integrity, which has suffered severely following the well-publicized audit failures involving the recent financial frauds. Given the recent revelations of fraud in the mutual fund industry and the travel billing scandal involving the largest accounting firms, this section argues that audit committees, the accounting profession, the PCAOB, and the SEC should proactively seek to prevent another crisis in confidence and should try to identify any situation in which an auditing firm could place its or its employees' interests ahead of the investing public. Unfortunately, the auditing profession cannot afford another crisis in public confidence. Recalling the Trojan horse, the auditing profession has more to lose from a further decline in the public's trust than it has to gain from the additional fees.[201]

If an auditing firm embraces "total independence" and refuses to provide any tax services to audit clients or their management and does not promote tax shelters to anyone, such a strategy may allow the firm to differentiate itself from other auditing firms and to use "enhanced independence" to compete for new audit clients. This competition could occur inside or outside the Big Four accounting firms.

3. *The Investing Public's Best Interests*

This article, like SOx, focuses only on public companies. Therefore, we should ask whether the investing public benefits when the independent auditor provides any of these previously described tax services to an audit client. Although any prohibition that limits an auditor's ability to provide tax services to audit clients will increase overall costs, those additional expenses will reduce the chances of future audit failures and the enormous losses that the recent financial frauds have imposed on investors. *The Wall Street Journal*

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200. *See supra* note 47 and accompanying text.

201. *See* Carpenter, *supra* note 199 (quoting PCAOB member Daniel Goelzer).

estimated the market capitalization losses arising from the recent scandals, compared to their five-year highs, as follows:

WorldCom Inc.	$156.10 billion
Qwest Communications International Inc.	$88.10 billion
Tyco International Ltd.	$76.98 billion
Enron Corp.	$66 billion
Global Crossing Ltd.	$22.01 billion
Adelphia Communications Corp.	$8.32 billion[202]

While the "net harm" to investors in these companies likely falls well below the amounts based upon the highest market capitalizations during the previous five years,[203] the general decline in investor confidence seemingly caused even more extensive losses in the overall capital markets. Although fees for audits, tax services, or probably both, would increase significantly, the additional costs seem insignificant relative to the hundreds of billions of dollars in losses that investors suffered in the recent financial scandals.

In addition, more and more investors increasingly believe that auditors should do nothing more than audit. The California Public Employees' Retirement System (CalPERS), for example, has repeatedly followed its policies to withhold votes for corporate directors who serve on audit committees that allowed the corporation's auditor to provide any non-audit services, including tax services, and, in some circumstances, to vote against ratification of those auditors.[204] By comparison, Institutional Shareholders

202. *Corrections and Amplifications*, WALL ST. J., Nov. 4, 2003, at A2. By comparison, a *Business Week* article in 2000 estimated the losses attributable to auditing failures between 1993 and 2000 as at least $88 billion. *See* Mike McNamee et al., *Accounting Wars*, BUS. WK., Sept. 25, 2000, at 156.

203. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 622–26 (1985) (suggesting that if securities fraud causes a company's stock price to rise from a price of, say, $10 to $100 per share, and then to decline to $1 per share once the broad market learns about the fraud, the social loss does not equal $99 per share because while some particular investors may have lost that much, other investors actually realized gains or suffered smaller losses).

204. *See* Carpenter & Cutler, *supra* note 155 (reporting that CalPERS would withhold votes for Warren Buffet and the rest of Coca-Cola Co.'s audit committee members because they authorized engagements that, among other things, resulted in $9.9 million in payments during 2003 to Ernst & Young, the company's outside auditor, for tax services and take similar actions against the members of the audit committees of Citigroup Inc. ($8.5 million in tax fees in 2003), Sprint Corp. ($2.3 million in tax fees in 2003), PG&E Corp. ($2.2 million in tax fees in 2003) and several other companies); Aaron Lucchetti & Joann S. Lublin, *Calpers Targets Directors Who Neglect Holders*, WALL ST. J., Apr. 16, 2004, at C1 (reporting that TIAA-CREF and the New York State Common Retirement Fund agree with CalPERS position on auditor independence, but that they have not withheld votes from all audit committee members when the audit committee has approved non-audit services); Bank, *supra* note 154 (reporting that

Services (ISS), a firm that advises institutional investors on proxy voting issues, focuses on the ratio between fees for audit and related services relative to fees for other services in determining how to vote on whether to reelect audit committee members to the board of directors and on auditor ratification issues.[205] Among other things, ISS requires that fees paid for tax services beyond compliance not equal or exceed audit and audit-related fees. Audit committees can insist that a firm other than the company's auditor prepare the company's tax returns and provide any desired tax planning services. Investors can vote against audit committee members who approve any non-audit services, including tax services, by the auditor and against ratification of those auditors.

B. Arguments Against Additional Prohibitions on Tax Services

Opponents of additional prohibitions on tax services would likely advance numerous arguments against the recommendations in this article. First, opponents might argue that accounting firms have historically offered a wide range of tax services to audit clients,[206] and that this historical practice has not presented problems. Although accountants provided tax services to their audit clients even before Congress first formulated the federal securities laws in the 1930s,[207] the increasingly widespread use of tax shelters, the recent revelations about the conflicts of interest at Sprint, and the tax shelter practices at Enron and WorldCom illustrate the very real conflicts that exist when auditors provide tax services to audit clients and their executives or promote tax shelters. New times commonly present new temptations, which often require revisions to out-dated rules.

As mentioned earlier, taxes can amount to approximately one-half of a public company's net income.[208] Consequently, opponents might next argue that an auditing firm's tax expertise enhances audit quality and that greater oversight over tax issues follows when the auditor also prepares the tax

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CalPERS withheld its votes for the directors and voted against ratifying Ernst & Young after the auditor provided $20.6 million in tax services to Hewlett-Packard Co. in fiscal 2003); *see also* Sheryl Stratton, *Accounting Board Won't Define Tax Services, but Will Inspect Them*, TAX NOTES TODAY, Oct. 16, 2003, *available on* LEXIS at 2003 TNT 200-4. Because the SEC's Final Rules contain various transitional rules that grandfather engagements that existed before May 8, 2003 for certain nonaudit services performed before May 8, 2004, I would hesitate to apply any "bright line" tests to any fiscal period beginning before that later date. *See* 17 C.F.R. § 210.2-01(e)(1) (2003).

205. *See* Stratton, *supra* note 204.

206. *See* Final Rules, *supra* note 12, at 6017.

207. *See id.* at 6017 n.103.

208. *See supra* note 175 and accompanying text.

returns.[209] Firms less familiar with the client's tax situation may not provide the highest quality audit services. Under this view, the informational synergies from a multidisciplinary practice actually improve audit quality.[210] Similar to the need for an auditor to understand the design and implementation of financial information systems, auditors need tax expertise. Any shift in tax work from registered public accounting firms to law firms or tax consulting firms could discourage tax professionals from pursing tax careers in registered public accounting firms, which could adversely affect the talent pool available to advise during audit engagements. Such a scenario would lead to less independent review and less transparency for investors.

Third, in the release accompanying the SEC's final rules to enhance auditor independence, the Commission described tax services as "unique among non-audit services."[211] In addition to the long standing practice in which auditors have provided tax services to audit clients, the SEC pointed to detailed tax laws and the fact that the federal income tax laws give the IRS discretion to audit any tax return.[212] Although the Internal Revenue Code provides considerable detail, many "gray areas" exist in federal income tax law, and tax examinations and the related administrative proceedings typically require the return preparer or the taxpayer's representative to advocate on behalf of the audit client, an activity which violates that basic principles that Congress affirmed in codifying the list of impermissible activities that automatically impair an auditor's independence.[213] Unlike financial information systems design and implementation, tax services often require the preparer to serve as advocate for the client upon audit or in administrative proceedings. As a practical matter, publicly traded companies regularly undergo tax examinations. Although the audit rate for large corporations has dropped in recent years, the Internal Revenue Service nevertheless audited

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209. *See* Final Rules, *supra* note 12, at 6017.

210. *See* Richard W. Painter, *Lawyers' Rules, Auditors' Rules and the Psychology of Concealment*, 84 MINN. L. REV. 1399, 1426–36 (2000).

211. Final Rules, *supra* note 12, at 6017.

212. *See id.* Indeed, some practitioners have argued that the calculation of a corporation's taxable income begins with net income for financial accounting purposes. *See* Stratton, *supra* note 7. These practitioners point to the fact that Schedule M-1, Reconciliation of Income (Loss) per Books With Income (Loss) per Return, in a corporation's federal income tax return, requires the corporation to reconcile net income or loss for financial accounting purposes to the income or loss reported on the return. *See* INTERNAL REVENUE SERV., FORM 1120, U.S. CORPORATION INCOME TAX RETURN 4, (2003), *available at* http://www.irs.gov/pub/irs-pdf/f1120.pdf (last visited Mar. 25, 2004).

213. *See supra* note 47 and accompanying text.

almost one-in-three corporations with $250 million or more in assets—a proxy for publicly traded companies—during fiscal 2003.[214]

Both the SEC and the accounting profession have argued that auditors typically defend an audit client's financial reporting in SEC inquiries and investigations. To the extent that auditing firms provide factual responses to inquiries, the practice does not unreasonably jeopardize auditor independence. Once an auditing firm offers explanations for the client's financial reporting, the auditor has begun to advocate for the audit client and, at a minimum, has impaired the auditor's perceived independence.

Next, separating the audit and tax functions would unquestionably increase the combined fees that public companies would pay for auditing and tax services.[215] Admittedly, tax professionals less familiar with a public company's operations may not provide the most cost effective tax services. The question becomes whether the benefit from additional independence exceeds the economic waste from the additional fees and potentially lower quality services.[216] While adding tax services to the list of prohibited services will unquestionably increase the total fees that public companies pay for auditing and tax services, given unconscious bias and the enormous losses and damage from the Enron scandal and other recent audit failures, can public companies any longer afford not to pay increased fees for the benefit of their investors, employees, and communities?

The Big Four accounting firms have developed unique tax expertise and perspective, especially in the international arena.[217] Through their world-wide affiliations and investments in technology, the Big Four accounting firms can typically obtain answers to most tax questions in most jurisdictions within seventy-two hours. Most law firms simply cannot compete in that regard. Given the need for auditing firms to employ individuals with tax expertise to examine an audit client's tax returns and tax reserves, economic considerations and the need to keep audit fees as inexpensive as possible would suggest that registered public accounting firms could use the time that their tax experts do not spend on audit matters to perform tax compliance and

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214. *See* Transactional Records Access Clearinghouse, *New Findings About the IRS* (Apr. 12, 2004), *available at* http://trac.syr.edu/tracirs/newfindings/current/ (last visited May 19, 2004) (reporting that the audit rate dropped from 347 per 1,000 returns in fiscal 1999 to 290 per 1,000 returns in fiscal 2003).

215. *See, e.g.*, Stratton, *supra* note 7.

216. In 1979, the Public Oversight Board published a study on the scope of services that auditing firms provided. The study could not locate any situation where rendering tax services compromised an auditor's independence. The study concluded that separating tax services from the audit could produce significant economic waste and might deny clients the best tax advice reasonably available. *See* Stratton, *supra* note 7.

217. *See* Stratton, *supra* note 190.

tax planning for non-audit clients. For this reason, this article does not advocate that auditors for public companies immediately stop rendering all tax services. Any auditing firm that provides tax services to non-audit clients, however, should exercise great care to ensure that the firm's "tax culture" does approach or surpass the firm's "audit culture."[218]

Finally, opponents will likely portray any ban on tax services to audit clients as a "one-size fits all" prohibition. Keep in mind, however, that such a prohibition would apply only to public companies in an effort to protect investors. In a perfect world, competition on independence issues might start a "race to the top." Given recent history and various financial incentives, a "race to the bottom" seems more likely to emerge. In essence, prohibiting registered public accounting firms from providing tax services to audit clients and their executives, and from promoting tax shelters to any taxpayer, represents nothing more than a minimum standard necessary to protect investors.

Fundamentally, the most significant problems arise when auditors must review their own work. In my perfect world, auditors would provide only audit services to audit clients.[219] Tax consulting firms, likely employing accountants, lawyers, or both, would offer tax services to public companies and their executives.[220] Registered public company accountants would need to employ tax experts to help determine whether the client had appropriately determined tax expense and established adequate tax reserves.[221] A truly independent audit can only occur when someone other than the preparer reviews tax returns and assesses the tax reserves.

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218. The emergence of a "consulting culture" at Andersen ultimately led to the firm's demise. *See* Barrett, *supra* note *, at 163.

219. Because the world rarely, if ever, attains perfection, however, "acceptable practices" would allow an auditor to perform tax compliance work and tax planning work unrelated to tax shelters for non-audit clients. As mentioned earlier, such practices would allow auditing firms to employ tax experts who could use any time not spent on audit matters to perform tax compliance and tax planning work for non-audit clients.

220. While the Final Four accounting firms continue to offer certain consulting services, only Deloitte & Touche has not sold or divested its consulting business. Pricewaterhouse sold its consulting practice to International Business Machines Corp., KPMG's consulting practice became BearingPoint, and Ernst & Young sold its consulting practice to Cap Gemini Group USA. *See* U.S. GEN. ACCOUNTING OFFICE, ACCOUNTING FIRM CONSOLIDATION: SELECTED LARGE PUBLIC COMPANY VIEWS ON AUDIT FEES, QUALITY, INDEPENDENCE, AND CHOICE, GAO-03-1158, at 4 n.5 (2003), *available at* http://www.gao.gov/new.items/d031158.pdf (last visited Mar. 25, 2004).

221. Over time, the various tax consulting firms would likely develop reputations that the auditor might rely on, at least to some extent, during its review of the client's financial statements.

CONCLUSION

This article has described the potential conflicts of interest that arise when auditors provide tax services to audit clients or promote tax shelters in a post-SOx world. In an effort to prevent further damage to the auditing profession's reputation, the public's confidence in the capital markets in this country, and the U.S. economy generally, this article urges individual auditors, auditing firms, the accounting profession, audit committees, and investors to enhance auditor independence further and to take those actions necessary to preclude auditors for public companies from providing tax services to audit clients or promoting tax shelters to anyone. While various tax services present potential conflicts of interest in differing degrees, drawing lines between different types of tax services, such as tax return preparation, tax consulting, and tax planning, presents very significant practical difficulties. Recognizing these practical difficulties, this article recommends a "bright line," best practice that would bar registered public accounting firms from rendering tax services to audit clients or their executives and promoting tax shelters to anyone. If an auditing firm embraces such a "total independence" policy, the firm may gain a competitive advantage in attracting new audit clients. Such an approach might even allow one or more firms to compete favorably with the existing Big Four accounting firms, reducing consolidation in the industry. Alternatively, boards of directors and audit committees may listen to the advice from large institutional investors and refuse to preapprove various tax services, especially questionable tax shelters from any public accounting firm.[222] More and more investors increasingly believe that auditors should do nothing more than audit.

If these groups fail to address the problem in the very near future, the PCAOB and the SEC should act. PCAOB member Daniel L. Goelzer has expressed his opinion that the Board will likely not engage in any rulemaking in the near future. He has added, however, that during its inspections, the

222. *See* Goldwyn, *supra* note 180. Policy setters might describe a strategy as "questionable" if an independent advisor assesses that the IRS would more likely than not *challenge* if it knew the underlying facts. The Conference Board has urged directors to avoid "novel and debatable" transactions. *See* THE CONFERENCE BOARD COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE, FINDINGS AND RECOMMENDATIONS 37, 42 (2003), *available at* http://www.conference-board.org/pdf_free/758.pdf (last visited Mar. 25, 2004).

Board could look at whether rendering certain kinds of tax services to audit clients will raise independence issues.[223]

Given the challenges in identifying exactly what services go beyond tax compliance and routine planning, or in distinguishing tax shelters from other types of services, the PCAOB and the SEC should seriously consider a complete ban that prohibits registered public accounting firms from providing any tax services to audit clients and from promoting any tax shelters. While better solutions, such as encouraging auditing firms to compete for audit engagements on independence grounds, may eventually emerge, neither the investing public nor the auditing profession can afford to wait much longer. SOx's auditor independence provisions have built a Trojan horse that threatens both the auditing profession and the investing public.

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223. *See* Stratton, *supra* note 204. For example, if an audit client engaged in a listed transaction that the Internal Revenue Code and related Treasury Regulations require the client to disclose to the IRS, the Board's staff could try to determine whether the auditor initiated the transaction. If so, the Board could try to determine whether the transactions impaired the auditor's independence. *See id.*