A Path Forward–Best Practices and Possible Policy Changes

*By The Honorable Bill Gradison, Lindy L. Paull, Michael P. Reilly, Roger D. Wheeler, William J. Wilkins and Robert S. Wylie**

MS. PAULL: I'd like to start this discussion with one of the comments Matt McKenna made yesterday morning. Matt framed our challenge in operating in this age of transparency, to reach the quality goals that all parties that come to the table are expecting of us, starts with conversations instead of confrontations day in and day out. Each of you are exercising your judgment in this environment taking into account the best you can all of the competing policy goals, in trying to deal with your day-to-day operations. He suggested that effective communications and rational judgments are what are going to help you navigate through this process. So, we want to spend our time delving into the competing forces that you are facing as you operate in this age of transparency.

We've broken our panel down into several key discussion areas, including the expectations of government regulators. We have already heard from the SEC. We have heard from the FASB, the board that sets standards for accounting. Now, we're going to hear from the Acting Chairman of the PCAOB on their expectations for audit quality. We're also going to discuss disclosure issues, the importance of certainty in tax positions, enterprise risk management, and the importance of independent tax advice.

So, without getting into the details, let me introduce our panelists. First we have Roger Wheeler, the Chief Tax Officer of General Motors. He has spent a long and significant tax career at General Motors. Next is Bill Gradison. Bill was appointed to the PCAOB in 2002 and is one of the original members of the Board. In fact, four of the five original members are still sitting on the Board. Last summer, Bill was appointed to an additional five-year term and last December, he was appointed Acting Chairman of the PCAOB. Bill Gradison brings a tremendous background in finance, health care, public service, and he's a terrific person to guide the PCAOB. Next on the panel is Mike Reilly, Vice President of Tax for Johnson & Johnson. Then, we will hear from Rob Wylie, the Vice President of Tax for PerkinElmer. Bill Wilkins, Co-Program Manager for the Symposium, is a Partner with Wilmer Hale, and has spent almost 30 years practicing tax law, either as a lawyer in private practice or seven or eight years at the Senate Finance Committee. We have a really good panel for you this morning. So, without further ado, let's welcome our keynote speaker, Acting Chairman of the PCAOB, Bill Gradison, to discuss the perspectives from the PCAOB.

HON. GRADISON: Thank you, Lindy, and thanks, ladies and gentlemen, for the opportunity to be here. In an earlier life, I really considered taxes in a sense to be my first love. I had been on the faculty, a very junior

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member of the faculty of the Harvard Business School for a couple of years and then came down here to the Treasury as Assistant to the Under Secretary. I know it was a long time ago, and I hate to date myself, but we were working on the 1954 Code while I was there. I was asking Bob a few minutes ago whether the regulations ever got finished, but I think I better not go there. It is a pleasure to be with you today, especially because I was invited by two old friends from whom I learned so much over the years. I grappled with tax issues for 16 years as a member of the Committee on Ways and Means, better known inside our committee room by some of the members as the Committee on Woes and Moans. Fortunately for me and for the nation, folks like Doug Bates and Bob Shapiro were there to advise us so if we got it right, we got it right, and if there was a mistake, we had somebody we could point to. When I left the House in 1993, I asked myself what legislative initiatives I felt best about, those which might in my own mind justify having spent 18 years in the House, and one involved taxes very specifically, which was the indexing of the individual income tax, which was accomplished with the special help of Senators Bill Armstrong and Bob Dole. The other initiative, since I said there were two, was adding hospice benefits to Medicare, which Leon Panetta of California and I worked on together.

Now having achieved my goal of making the tax system simpler and fair, I turned my attention to health care, did that for a long time, and having assured that every American was receiving quality health care at an affordable price, I have now turned my attention to protecting investors by auditing auditors as a founding member of the PCAOB Board. In other words, look out, folks. Those of you who track the oversight of auditors, and I hope those of you who are investors in our public markets will know that PCAOB has been in place for just over three years. It was established by Title I of the Sarbanes Oxley Act[1] and was a direct result of the financial failures at WorldCom and Enron and related collapse of Arthur Andersen, we are, as Congress decreed in the Act, a private sector nonprofit entity. Typically, the Board does comprise five members appointed by the SEC. We're down to actually the original four since Bill McDonough, who served with such great distinction as our first chairman, left us around the first of December. Before we go any further, I want to make it clear that the views I express today are my own and not those of the Board or of the staff of PCAOB. It took me a long time to be able to say PCAOB that smoothly. It doesn't come very easily.

After three years of helping develop our congressionally-mandated oversight of accounting firms, I believe that this year will be the most important year so far for the PCAOB, and let me explain why I feel this way. All of the principal milestones I see this year relate to our statutory mandatory to inspect the accounting firms that are registered with us. As you probably know, any accounting firm that wishes to audit the financial statements of a company that trades in U.S. markets, that is issuers, must be registered with PCAOB, and any registered firm that audits at least one public company client must be inspected by the Board at least once every three years. Those with more than a hundred public company audit clients, there are eight of those in the United States and one in Canada, must be inspected annually. This year, we will be approaching the end of the first three-year inspection cycle for some domestic firms that audit fewer than a hundred public companies, and also for the first time, the Board will be assessing the degree to which accounting firms have addressed quality control deficiencies which were identified during prior year inspections. To the extent that firms' efforts to address the deficiencies do not satisfy the Board, we are required by the Act to make the uncorrected deficiencies public. Also for the first time, in the next few months, I expect the Board will open the window to our inspection findings with regard to all of the 2004 domestic firm inspections. While PCAOB is prohibited from identifying specific audit firms or issuers, the Board can publish reports that provide an overview of the results of its inspections of quality control at registered public accounting firms. These reports will, for the first time, provide a baseline against which future inspection findings can be compared, providing an opportunity not only to observe where quality control weaknesses have been identified but also, in years to come, to judge whether progress is being made in achieving the Board's statutory mission: to oversee the auditors of public companies in order to "protect the interests of investors and further the public interest in informative, fair, and independent audit reports." Notice that the focus of the statute is on protecting the interest of investors. It doesn't focus on protecting the interest of the issuers or the auditors. I think that's significant.

The Board issued its first such report, that is a comparative report, of quality last November when we reported on the initial implementation of our standard for audits of companies' internal control over financial reporting. I expect these reports will be very useful to

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auditors, issuers and investors alike, and eventually to tax specialists, such as yourselves. Indeed, taxes have been an important part of PCAOB's work, both in our standard-setting and inspections. This should not be surprising because taxes are almost always material in the auditing of the financials of public companies. Last year, the Board adopted rules relating to auditors' ethics and independence as they relate to tax services. The rules are pending before the SEC and identify three circumstances in which the provision of tax services impairs an auditor's independence. One rule treats registered public accounting firms as not independent of their audit clients if they enter into contingent fee arrangements with those clients. Another rule treats a registered public accounting firm as not independent if the firm provides services related to marketing, planning, or opining in favor of a tax treatment on a transaction that is based on an aggressive interpretation of applicable tax laws and regulations. Transactions that are listed by the Treasury would fall into this category of prohibitions. Yet another rule, the third of the three I mentioned, would treat a registered public accounting firm as not independent if the firm provides tax services to certain members of management who serve in financial reporting oversight roles at an audit client or to the immediate family members of such persons. The rules further implement the Act's requirements by strengthening the auditor's responsibilities in connection with seeking audit committee preapproval of tax services. Specifically, they would require a registered public accounting firm that seeks such preapproval to describe proposed tax services engagements in writing for the audit committee, to discuss with the audit committee the potential effects of the services on the firm's independence and to document the substance of that discussion. As I said, when the Board proposed these three rules relating to auditors' independence and ethics, obtaining both audit and tax services from the same firm often proves helpful to issuers in light of the auditor's detailed knowledge of the issuer's business. I felt that way then, I feel that way now. As a result, whether an issuer's auditor is engaged to provide tax advice is properly left to the discretion of the audit committee, and I believe the rules as adopted provide a useful and targeted approach to auditor independence that is in the public interest. The rules adopted by the Board are an important part, but only a part, of audit standards bearing on the relationship between audit quality and tax services.

In addition to the approved rules and other current board standards, there may be others on the horizon which could enhance the quality of the auditing of tax provisions. I have in mind a standard on communications with audit committees, which the Board may consider this year. The board standard on audits of internal control over financial reporting, Auditing Standard No. 2, also should be mentioned in this regard. Internal controls over the reporting of tax reserves require the same level of scrutiny by management as other internal controls. This matter was highlighted in May of last year by Jefferson Wells International and the Institute of Internal Auditors in their Sarbanes-Oxley Implementation Survey. In the portion of that report on Gaps in Internal Controls, they stated, "There is also evidence that controls within the tax area tend to receive less attention than they warrant. Federal taxes, state sales and property taxes, for example, usually originate from a diverse range of feeder systems. Each of these information sources as well as the subjective judgments used to determine tax exposure requires effective controls and processes." As you know, the importance of this issue was highlighted by Chairman Cox's presentation to you yesterday morning. PCAOB's main role in ensuring that the provision of tax services enhances or at least does not weaken audit quality may come through the inspection process. Future inspection reports may help inform the Board of the impact on audit quality of the Board's rules relating to tax services and assist the Board in determining whether additional steps need to be taken with regard to the role that auditors play in providing tax services to their audit clients. Our inspectors may focus on a variety of tax issues related to a firm's audit practice. For example, our auditors may look to see whether the audit team was appropriately involved in the audit of the income tax accounts and whether errors in those accounts were properly recorded and communicated as required to the audit committee. Our inspectors are also keenly aware, as firms should be, of the independence boundaries around tax work. To comply with independence requirements, the auditor needs to leave it to the issuer to perform certain computations and analyses related to the tax provision and deferred tax assets and liabilities. The auditor may not perform those computations and analyses for the issuer and our inspectors will look to see whether an auditor crosses that boundary, and, of course, in the tax area and other areas, our inspectors look at the adequacy of audit documentation. Appropriate documentation of audit procedures performed in income tax accounts, including both contingency reserves and the core

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income tax accounts themselves, is plainly important. Without audit documentation, it may be difficult or indeed impossible to determine reliably whether general income tax reserves, deferred tax liabilities, or income projections supporting the valuation of deferred tax assets were sufficiently audited, tested or evaluated. I hope and fully expect that the results of our inspections will result in public reports that will be helpful to auditors, issuers, tax practitioners and, most importantly, as I said earlier, investors.

The Act gave the Board broad authority not only to register and inspect public accounting firms but to set standards for auditing and professional practice as well as to investigate and discipline registered firms for violations of the Act, the rules of the Board, and securities rules as they relate to the audit of public companies. By setting standards for audits and professional practice, the Board can play a strong role in directing how auditors perform their duties on behalf of investors. I already mentioned that the Board may consider a standard on auditors' communications with their clients' audit committees, but we have several other potential standards in the works as well. Among the areas that the Board is exploring for possible standard-setting are elements of quality control at registered accounting firms and engagement quality reviews, also known as concurring or second party reviews.

As the Board considers what auditing standards to take up, we rely heavily on our Standing Advisory Group, a truly distinguished group of 31 individuals with expertise in investing, accounting and auditing, corporate finance and corporate governance. In fact, just yesterday, we met with the group all day to hear their views on auditors' use of specialists in performing audits as well as risk assessment and the auditors' consideration of materiality in planning an audit. We also heard a very lively discussion of litigation-related clauses in audit engagement letters and what those clauses might mean for an auditor's independence. The Standing Advisory Group provides valuable guidance to the Board as we consider auditing standards, but it is by no means our only source of input. The Board and the staff meet formally and informally with investors, auditors, academics, leaders of small and large companies to obtain feedback about our work, and we always seek public comments on the standards and rules that are proposed by the Board. Our standards and rules are enforced through our Inspection Program, as I indicated, not just through threat of public exposure in the inspection reports, but through encouragement that the firms and their individual auditors correct missteps and errors very quickly, driving improvements in firms' public company audit practices on an ongoing basis. In other words, our emphasis is on improving audit quality, our so-called supervisory model. Of course, when recalcitrance, ignorance, incompetence or outright malfeasance by auditors threaten the public trust in financial statements, the Act gives the Board ample authority to curtail or deny the ability of those auditors to opine on the financial statements of public companies. One of the areas that will receive close attention from our inspectors this year is the firm's performance of audits of internal control over financial reporting. As part of PCAOB's efforts to improve the efficiency and effectiveness of those audits, our inspectors, as they go out into the field this spring, will be making a focused effort to ascertain that auditors have implemented the guidance issued by the Board last May 16th. That guidance encouraged accounting firms to integrate their audits of internal control with their audits of the clients' financial statements so that evidence gathered and tests conducted in the conduct of either contribute to completion of both audits, to exercise judgment, to tailor their audit plans to the risks facing individual audit clients, the so-called risk-based approach, and to use a top-down approach that begins with company-level controls over financial reporting. In 2005, we established and dispatched a team of highly trained inspectors to conduct inspections of audits of internal control over financial reporting, ICFR, by the eight largest U.S. firms. To communicate to firms the findings of the ICFR inspection team and to provide ongoing guidance and direction for the subsequent year's ICFR audit, the Inspection Division leadership met with the leadership of the firms beginning in the fall of last year. The objective of these meetings was to provide feedback to the firms on their implementation of Auditing Standard No. 2 and to discuss effectiveness and efficiency issues based on observations obtained during last year's inspections. The meetings were also intended as a mechanism to obtain information on improvements the firms had made or anticipated making to improve the effectiveness and efficiency of their integrated audits going forward.

Our approach to inspections this year will change somewhat from what it was last year. This year, we will integrate our inspections of ICFR audits into our existing inspection process rather than having a separate team to mirror our expectations that the firms will integrate ICFR audits into their existing audit process. The overall approach for 2006 will be for our inspectors to conduct inspections of the firms' integrated audits

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with emphasis on how the firms have implemented our staff Q&As and the November 30th board report from last year. An integrated audit, of course, is one where the audit of internal control over financial reporting and the audit of the financial statements are performed in tandem to arrive at opinions for both audits. Because there should be a close correlation between the audits, the impact of issues identified in one audit must be assessed to determine not only its impact on that audit but the impact on the other audit as well. Our intent is that inspections conducted in 2006 will focus on whether the firms have gained efficiencies, and I stress that word efficiencies, principally by implementing the guidance in our staff Q&A and in the Board's November report. Through periodic meetings with the firms, our inspectors will identify areas where firms need to be more efficient in the audit procedures they perform. The inspections of ICFR audits are a big part of why I expect 2006 to be such an important year in the life of the PCAOB. This will be my fourth year with this remarkable organization. I appreciated the opportunity that was given to me by the SEC way back in 2002 to serve as one of the founding members of the Board. Now, as I see the PCAOB emerging from its start-up phase to its present capability to carry out the responsibilities assigned to it by the Congress, I'm even more grateful for the opportunity. Thank you very much.

MS. PAULL: Thank you, Bill. The next part of this panel is going to delve into the issues that have been discussed over the last day and a half in previous panels. The first set of issues is, how to strike the right balance on disclosure. We heard a lot about the competing forces that you need to take into account when you are considering disclosure internally and externally. We heard from the SEC Chairman about accurate and timely disclosure. We heard from the investor sector that they want to hear about bad news as quickly as possible, even if the details are not fully developed. We also heard to be cautious, if you have got some good news, waiting until you really have it buttoned down. So, with that background, Mike Reilly is going to lead our discussion on disclosure.

MR. REILLY: I think we've all learned a lot in the past day and a half and I did want to try to outline what I've learned about disclosure. We are asking the question: what does the public want to know about corporate tax positions? As you know, TCPI conducted a Survey[2] and it seemed to indicate that there has been heretofore a pretty narrow focus by the analyst community. The Survey asked the question, have analysts inquired about a particular item in the past two years, and 81 percent of the Survey participants have had analysts ask that question in the past two years. After that, the response drops off pretty precipitously. The next most common question was the impact of tax legislation on a company, and 52 percent of the Survey participants have had analysts ask that question, and after that, it goes down significantly more again. Even on the ongoing cash tax rate, only 26 percent of the Survey participants had an analyst question on that subject. On the level of reserves, only eight percent have had that question.

However in yesterday's public disclosure discussions, we did hear a speaker from the analyst community, Jack Ciesielski, and he poured a little bit of cold water on our Survey. He said that he really didn't agree and that analysts who are taking a long-term view of a company are very interested in whether tax issues would affect future earnings, that people would want to know much more than just the effective rate. Our government and regulatory speakers related a common theme on what the public should know. Chairman Cox said one of the SEC's goals is to ensure that information is accessible and accurate to the retail investor. Carol Stacey echoed that and said the goal is to ensure effective communication to the investor. She said that we need to provide the readers of financial statements with sufficient information about the quality and variability of earnings and cash flow. There was also expressed a recognition about the complexity of the tax and accounting rules and the challenge that represents to the investor community. Bob Herz mentioned that he has been engaging in a war on complexity. If information is overly complex, Bob said, then we are not really serving the purpose of improving the information provided to investors. From Don Nicolaisen's 2004 speech,[3] we heard that tax reporting has historically been opaque and that is why tax information is highly sought after in the due diligence work associated with a potential acquisition. Chairman Cox pointed out that one-third of the material weaknesses under 404 related to income taxes, although he pointed out that 80 percent of that one-third was related to companies with less than $500 million of revenues. So, what does this all mean for disclosure? Again, there seemed to be a common message regarding disclosing material or significant items. However, Colleen Cunningham, representing the CFO community, expressed concern that the materiality threshold seems to be getting lower and that everything is seen to be material by the regulatory

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boards. Although Don Nicolaisen said that financial statement users should understand whether a tax item results in a significant impact on earnings and cash flow, Carol Stacey said disclosure around taxes should include reasons why a company operates at a rate which is different from the statutory rate and whether those reasons are one time or continuous.

The second disclosure panel discussion approached the issues through a transfer pricing example. Meredith Cross addressed disclosure from an SEC enforcement perspective. She pointed out that enforcement actions are brought when bad things happen and they were foreshadowed but not disclosed. While there is the desire to balance the company's interests in confidentiality with disclosure, we heard yesterday that there really is no exemption from disclosure in the tax area. I think it was pretty clear from the panel yesterday that bad news should be disclosed as early as possible, certainly material bad news. The panel also pointed out that because of the general conservatism of tax reserves, a significant event is more likely to result in an increase in earnings. The point was made that disclosure of a contingent gain should wait until the event is finalized. The SEC wants a higher level of certainty when disclosing good news. Regarding the uncertain tax position project, before the discussions yesterday, I was going to point out that it is important to recognize that the uncertain tax position project was initiated at the time when there was significant press coverage about companies using corporate tax shelters that were heavily marketed. With that in mind, I thought one could reasonably ask for more disclosure of participation in so-called listed transactions, for example. However, after hearing the speakers yesterday, it is clear that more than that will be required. As the FASB deliberates the disclosures with respect to the uncertain tax position, I think the investor community has an interest in ensuring that the additional disclosure requirements are not unduly burdensome and consistent with the theme that disclosures should be relevant. I hope the rules issued regarding disclosure retain a realistic definition of materiality and while Bill Gradison pointed out that taxes are always material, I think it's clear that not every single aspect of the tax provision is material. In going back to Bob Herz's remarks, I would just like to close on that, I think it's important to keep in mind that if information is overly complex, then we are not really serving the purpose of improving the information provided to the investors.

MS. PAULL: Thank you, Mike. We just received a question and maybe it is worth following up with you on striking a balance on disclosure. This question addresses uncertain tax positions and tax reserves, in general. If there are specific issues in the reserves that have not been raised with the tax authorities, do you have any kind of feeling of how they should be handled in terms of disclosure?

MR. REILLY: Well, I guess we had a discussion yesterday about the corporation's interest in maintaining confidentiality because we didn't want to provide the tax authorities with a roadmap, but I think our speaker from the analyst community didn't think that that was all that important to the investor community. I think we tried to paint the picture that the investors have an interest in our not giving the tax authorities the answer to our audit weaknesses, but I do think it does get back to the concept of materiality, and it is the issue that you've set up a tax reserve for. Does it relate to an item which is material to the ongoing tax rate or even the current period tax rate in a material way? So, I think that we have to still exercise judgment in that area.

MS. PAULL: Now, let's turn to Roger Wheeler, who is going to lead a discussion in the importance of tax certainty in this environment.

MR. WHEELER: Anybody remember when taxes were viewed as a black box? It wasn't too long ago. The tax numbers were always a mystery and nobody really wanted to know what they were. We'd kind of poke a number out at the end of every quarter and people were glad to accept it. But I think those days are obviously long gone. The tax director today has many, many more stakeholders, nontax stakeholders looking over his or her shoulder. Today, taxes are one of the most important things I do. In fact, the Survey revealed accounting for tax and avoiding financial statement error as the Number 1 objective of tax management. Eighty-three percent viewed that as the most important priority in the tax department. So that's a big difference from a couple of years ago.

You get the point right now that nobody really cares whether you file your federal return on time or nobody really cares whether you have a big audit adjustment or not, what they really care about is whether or not you've screwed up the tax numbers. So you really, really have to pay attention to that. The risks and the consequences are far greater than they ever have been before. That's a problem because most of us were trained to prepare fine-tuned tax analysis or to be tax lawyers, to manage tax controversies and get favorable settlements. We weren't really trained to be tax accountants. So, nowadays, we have to be, and my good friend Tim McCormley over at the TEI,

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has expressed it this way: "The square peg of taxes is being crammed into the round hole of accounting." I think that's a very true statement.

We are now confronted with the two things that a tax director has always feared the most: speed and certainty. Now we've got to get it right the first time and we've got to get it right, right now. We've got to get it right this quarter or we're going to be in deep trouble. The accounting laws are so unforgiving, there's not much room for error. You can look at it this way, that if my company did a transaction this quarter, it used to be we'd think the tax aspects aren't going to see the light of day until maybe four or five years from now when you have to settle out with the IRS and, we didn't really care if we settled out with the IRS even then, because tax issues, they were like good red wine: they only got better as every year passed. You could tweak the issue, you could think about it a little bit and in the end maybe a favorable precedent would come down and your case got better. Your likelihood of success improved year after year.

But now, it's a little bit different. The accounting firms are not going to wait until you file your tax returns. This is February. My tax return for a transaction right now will be filed in September of '07, and I can't wait until September of '07 to come up with the right answer. I need to have it probably by April 2006, some time in early April, for the quarterly closing. Once I make that decision, I'm really going to have to stick with that unless I have some demonstrable situation that I can really point to that causes a change. So, accuracy certainty is far more important than it ever was.

The question is how do you get certainty in a world where tax situations are inherently uncertain? I think there's a couple ways, and many of our speakers during the course of the last day and a half have given us some ideas on how you can get certainty. The first way you can do it is to be current in your IRS audit and I don't really want to rehash that. We had a really good panel on that. There are a lot of prefiling issue resolution mechanisms that we can take advantage of and there is a lot of postfiling dispute resolution mechanisms we can take advantage of. Those are all very successful. Most taxpayers from our Survey think that those currency initiatives are working very well and are positive that they are becoming more and more important in today's world. The IRS, by all accounts, is pretty satisfied with the situation as well.

So, if we're looking at a best practice, I think we need to look at LIFE, Fast Track, APAs, PFAs, PLRs, and everything else the IRS might be willing to work with us on in terms of issue resolution. Having said all that, I'm a little less sure that CAP is going to be a situation that most of us will embrace. I know some companies are using it and like it and the IRS is certainly promoting it, but I'm not sure that's going to be the right solution for everybody. I don't think it is the silver bullet for the rank and file taxpayer. So, we need to work with these other situations. If we can be in a LIFE audit two years from being current rather than eight or 10 or 20 years, we're in far better shape and we can do our financials with greater certainty than we ever could do them before.

So, what else can we do? Well, one of the things tax personnel have always complained about is not knowing what's going on in the corporation, not being included when big transactions are coming down, not being in on the leading edge of where the company's going. Well, nowadays, I see an increasingly large number of taxpayers telling me that, well, I'm being brought into things a lot quicker than I ever was before. I'm being asked for my advice early on in transactions, and it's not because they want the right tax answer. They want to get the accounting right. They need to bookkeep it and they don't want a material weakness or they don't want to have a bookkeeping error. Tax people are being brought in much quicker than before. Obviously that's a best practice.

Also, I think you know there was this tension that was created between the auditing firm and the taxpayer or the tax department about two or three years ago and everybody was at each other's throat; the situation wasn't very good. It was a little more hostile than it had been before and that was a rough situation, but we have all worked through that difficult time and nowadays you can get a lot more certainty by including the accounting firm early in the transaction. If today is February 10th and you've got two months to get the accounting right, you better get the accounting guy involved right away and work it out. If these are some very complex situations, we need to be more collaborative in how we approach things. I think most people are. So that's another best practice that I see.

One of the things we touched on over the last day and a half, and maybe more this morning than yesterday, but we really haven't explored, is the situations with overseas accounting and overseas accounting for tax-sensitive situations. I have heard about an awful lot of situations where the overseas accounting staff, I mean maybe these are small companies, small subsidiary companies, the overseas accounting isn't as topnotch

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as it would be at the parent company. I have talked about it with other tax directors. Sometimes the accounting is pretty superficial actually and you don't always get a good answer. Sometimes you get a political answer. Sometimes you get a regionally-driven answer. The way to resolve that, what we've found and what other people have found, is that you need a degree of standardization, commonization, centralization; you need a certain centralized control and decisionmaking. If you disperse decisionmaking to regions or to local units, you're going to more likely than not get a political decision, a local decision or a decision that's going to benefit a particular local company, and not the total enterprise. So, it's really important to look at tax reserves on a centralized basis and take that responsibility away from the local operations, particularly in situations where the tax exposure might exist locally because of cross-border situations and there may be a balancing. You don't want everybody accruing the exposure and nobody accruing the correlative adjustment. It's a big problem if you don't look at it in a holistic way. So that would be a very best practice.

Finally, down the road, other ways that we might improve certainty, would be to bring greater conformity between taxable income and book income. That will increase certainty because you don't have so many book to tax adjustments. In fact, you could get the most certainty if you simply paid tax on book income. Not a lot of people seem to like that idea, but I bet you half of the companies should—if you have a deferred tax asset, you are going to benefit from it. So, about half the companies in the world would benefit from it. It is something that probably we'll never get to, but the more you can eliminate the M-1 adjustments, the more you're going to be able to have a greater degree of certainty and that gets to the whole idea of simplification, taking complexity out of the system.

MS. PAULL: Thank you very much, Roger. The next issue that we're going to grapple with here is managing risk. We have heard throughout the Symposium that taxes are a significant risk factor for any corporate enterprise, and now Rob Wylie is going to lead us in that discussion.

MR. WYLIE: Thank you, Lindy. Let me begin by noting that the Survey found that avoiding financial statement error is the most important challenge to the corporate tax practice also found, by a significant margin, that enterprise risk management ("ERM") is the least important challenge going forward. I have a different view of the importance of ERM because financial statement error is an enterprise risk.

First of all, we know the corporate tax practice environment is rapidly changing. Nonetheless, we as tax professionals have long possessed a strong grasp of risk management. In addition to ensuring compliance with rules and regulations, our primary value-add has been to evaluate and capture opportunities and balance risk and reward to improve income and cash flow. So, has our practice really changed in the past few years? In fact, yes.

The broad nature of change in the corporate tax practice has been discussed by earlier panels and by this panel. Many new restrictive rules and regulations have been enacted. Increased, but not always clear, disclosure requirements have been promulgated by the alphabet soup of the SEC, PCAOB, FASB, IASB, IRS and GAAP auditors, not to mention statutory auditors and other tax authorities worldwide. How have these new requirements been manifested? New legislation, regulations, statements and, too often, in myriad pronouncements, speeches, dinner meetings, seminars and other events that we do not and cannot all attend.

Greater regulation is enforced by (1) increased examination and greater documentation, (2) more rigorous review by our GAAP auditors, (3) independent oversight now of our auditors' work papers by PCAOB, (4) SEC-set regulatory expectations for Board oversight of risk management, all of which are piled on top of tax shelter listed and reportable transaction rules. Collectively, these rules may have cooled the market for aggressive planning and reduced temptation and risk, but we are still living with the hangover. Still to come, we have the new FAS-109, which will likely prescribe a significant change in the way tax risk will be accounted for and disclosed.

Why is avoiding financial statement error the most important task for us? It is because the results of such error, restatement, material weakness and negative impact on reputation can destroy substantially more shareholder value than bad tax planning. Our need to apply ERM principles is clear if we are to minimize the possibility of restatement and material weakness. If avoiding enterprise risk is the most important task we have going forward, how comfortable are we that the risks are fully understood and the right processes in place? Compare the system we have to calculate the tax provision with the financial accounting systems that our companies have to determine GAAP consolidated results. When one considers the increased granularity required to prepare the GAAP tax provision, the relative robustness of the supporting systems may make some of us uncomfortable. It concerns me.

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ERM starts with senior executive and Board thought leadership and flows all the way down to transaction level activity. ERM requires increased dialogue between senior leadership to create a consensus view concerning risk, that is, not just tax technical risk, but business risk, reputation risk, and now increasingly, financial statement risk. Broader integration into decision making and control processes are ERM techniques to reduce risk. We have heard how tax people are being brought into decision making earlier, but early involvement is not enough. Tax is increasingly being asked to prove not just the existence of the stated outcome, but the absence of any negative outcomes, that error does not exist. Of course, in the current environment, proof does not exist unless it is documented.

The successful conduct of business requires us to accept an understood and agreed amount of risk. Our job is to ensure that there is a common definition of risk and that each exposure, within agreed tolerances, is communicated. I believe that we are now in a zero defect environment. We are all aware of the challenges the corporate tax practice faces in securing resources necessary to achieve zero defects, so we must build teams, design systems, and implement processes to prevent error efficiently.

Are the path forward and the goals clear? We have all observed the competing forces and heard divergent views offered earlier during this Symposium. The good news is that opportunity exists for dialogue to make the way forward clearer. In order to frame best practice recommendations, I would like to reprise some of the discussion we have enjoyed at the Symposium.

Chairman Cox explained that his twin goals were investor protection and economic growth. Economic growth is based on the acceptance and management of risk, but protecting investors requires that that acceptance and management of risk be organizationally transparent.

Matthew McKenna, of PepsiCo., observed that transparency alone is a facile guide and that disclosure is not enough. It's one thing to disclose data. The question is, "Are we disclosing information that is useful?" Issues are not black and white and neither is the calculus that drives related disclosure. There are plenty of smart people in the corporate tax practice. Mr. McKenna observed that we have the wisdom to understand policy implications if we choose to, but that the tax practice has not always exercised the good judgment to implement such policy. Perhaps that is part of the reason for the environment we are in. Finally, he recommended, and our panel agrees, that we should continue to state positively what the policies should be. I think we see that, by our interaction and dialogue concerning FAS-109 and uncertain tax positions, we are having a positive impact on the process.

George Forster, the IBM Vice President of Global Taxes, pointed out that in evaluating disclosure, balance and relevance were essential components. Transparency should be reasonable and not unduly burdensome.

We were treated to a replay of Chairman Nicolaisen's comments from two years ago. Listening to his comments now, the impression I received was the importance of balance. When I first heard his comments, all I thought, as my eyes were being opened, was disclosure. Now, the need for balance is reverberating more clearly.

Robert Herz, Chairman of the Financial Accounting Standards Board, suggested a re-emphasis on concepts and principles. There is opposition to a principle-based approach, perhaps based on the perception that a principles-based approach may reduce certainty, increase variability and the potential for second guessing. He observed that APB-23 was retained, in part, because the foreign tax credit complexities of repeal were too great. I suspect many of you deal with tax accounting issues of equal or greater complexity on a regular basis.

If any of us are not addressing complicated tax accounting issues on a regular basis, I recommend reading the GAAP accounting authorities cited by Brett Cohen, Partner with PricewaterhouseCoopers. There is plenty of complexity, and ambiguity, in the tax accounting literature.

The Honorable Michael Oxley reviewed the success of Sarbanes-Oxley. He observed that first-year costs were coming down and, as we heard earlier, material weaknesses were concentrated in smaller companies, particularly those under $500 million of sales. The goal of Sarbanes-Oxley is complete, accurate, and timely disclosure of material information. Still, the corporate tax practice is still struggling to understand what investors truly view as material tax information.

Colleen Cunningham, the CEO of Financial Executives International, reminded us that Sarbanes-Oxley and related initiatives are investor-focused. She recommended that these initiatives should not be altered to suit tax authorities' compliance desires.

Conversely, IRS LMSB Commissioner Nolan told us that the IRS was working closely with the SEC and FASB to identify and assess compliance risk more easily. Here, we can see a clear example of where the forces are moving in opposition. IRS Chief Counsel

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Korb spoke of the compliance revolution. Many of us have experienced the benefits of a more collaborative process, whether that is LIFE, the CAP program, the TEI and LMSB joint audit initiative, or just increased dialogue and a better relationship with our tax auditors.

The observations we heard from Margaret Curry of Dell and Nanci Palmintere of Intel on their CAP Program experiences were positive and cautiously optimistic. They informed us that it is too early to reach conclusions.

We all hope that the M-3 will be used to focus audits and reduce needless compliance expense. Is that going to be the case or will the M-3 be used merely to increase our compliance and tax audit burden? Time will tell.

Contrasting opinions were also offered on the availability of privilege. Is the judiciary really more skeptical of the privilege, as suggested by Chief Counsel Korb, or is it just that the requirements and precedents are being rigorously enforced? Former IRS Chief Counsels Gideon and Williams both opined that the privilege still exists and it needs to be properly claimed and supported.

This morning, there was an interesting discussion concerning the role of the audit committee. Jonathan Levin of the Corporate Tax Roundtable took us through recent changes to the statutory and regulatory duties of an audit committee and recommended that the committee promulgate clear risk guidelines. Other panelists commented that audit committee involvement should be more supervisory and less involved, the committee should not manage what the corporate tax practice is doing and that risk judgment must be retained by the tax experts.

We heard an audit committee practice from Ken Petrini, VP of Tax at Air Products. Ken explained the process by which every new member of his audit committee is treated to a presentation on the tax function, where the key risks are, and what the Air Products ERM process is. Perhaps, the Air Products approach is a best practice to ensure that consensus decision-making on ERM is achieved.

So, I'd like to suggest a few best practices here. I think we have heard them all before, but I would like to hit them again. First, disclosure should be relevant and balanced. As we heard, get the bad news out early and don't broadcast the good news too soon. Early warning should not be applied to just external disclosure but internal disclosure as well. There are many internal parties and advisors involved in the public disclosure process. If we do not identify potential issues with other disclosure stakeholders, they will inevitably believe that they have been inadequately informed. It is better for the team to eliminate disclosure concerning unimportant issues than to discover a material item at the last minute and catch your peers by surprise.

Second, we need to continue our engagement of regulatory authorities and the discussion about principles, complexity and balance. We may not always like or agree with the end result, but I am certain that it will be improved for our participation.

Third, we must apply the abilities we use to execute the most complicated tax transactions to tax accounting and financial statement disclosure. For many of us, this represents a relearning of knowledge far in our past, though we certainly have the ability to do it. Judgment will enable us to do what is right. We are used to being second-guessed by tax authorities and we are in the best position to determine and do the right thing.

Fourth, increased currency, fewer undisclosed years are good. There are different paths and programs to get there and some issues may still, like fine red wine, be best resolved over time. However, building trust and relationship with the IRS is critical because within that relationship lays the foundation for the dialogue necessary to resolve issues effectively.

Fifth, privilege is still a potential tool for the precise. We need to work with our advisors to be sure that we get it right and we understand the purpose for which we seek the privilege. Further, we should collaborate with our GAAP auditors to satisfy their needs without compromising the best interests of our companies.

Sixth, with respect to the relationship between Tax and the audit committee, we should move from an exception-based reporting system to an agreed ERM paradigm ensuring shared consciousness about enterprise risk tolerances. A more engaged relationship does not mean meeting the audit committee every month or contacting the Board about every issue. Nor does consensus mean prescriptive requirements. Rather, it is our job to help the audit committee fulfill its statutory and regulatory responsibilities to oversee the operations of our companies.

Seventh, concerning internal investigations, I think the best practice is to avoid one. If you are engaged in an investigation, enterprise risk management systems have broken down. Remember, when the IRS criminal division shows up, it's time to stop talking and call the lawyers.

In summary, what is the corporate tax practice to do? We have a fluid, dynamic environment. Our organizations are changing. The requirements are

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changing. Expectations are changing. Resources are not increasing as fast of the requirements of these new challenges. So, we must be innovative in designing systems and processes. We must look for different ways to exert control over our companies. For example, it may not be a good idea to have internal audit examine the tax function, but it may be a best practice to use internal audit to examine the corporation and its operations to ensure alignment and consistency with its tax profile. In conclusion, we must be sure that our judgment and actions reflect the wisdom that our tax practices possess. Thank you.

MS. PAULL: Thank you, Rob for a very interesting discussion. Our last panelist is Bill Wilkins, and he is going to cover the importance of outside tax advice.

MR. WILKINS: As background, we have heard from other speakers that corporate tax departments have an increasing need for advice, but that the zone of confidentiality is quite small. There is a need to document the positions you are taking on tax reserves. However, your GAAP auditor has a reduced capacity to provide advice because of independence concerns, so you have to turn to other resources. There's a need to understand the issues that you will be presenting in your new cooperative relationship with your IRS auditor.

Finally, we have heard that resources are constrained inside your tax groups. Many issues need research, deliberation, collaborative discussion among thoughtful professionals and nuanced writing. People inside companies may not have time for this stuff, but outside providers make a living doing this. There are times when you should take advantage of those outside resources. Unfortunately, you cannot expect such advice always to remain confidential. The classic attorney-client privilege may not attach in the first place because of the purpose for which the advice was prepared; the privilege is easily waived; and you should expect waivers to occur because of GAAP audit documentation requirements. The work product privilege is available for advice that's obtained in anticipation of litigation, and you can't say that every item that you receive tax advice on is received in anticipation of litigation. We heard from Debbie Nolan and the IRS that in order to obtain audit currency, you have to provide openness. That degree of openness may require sharing of materials in ways that will cause you to lose privilege. Finally, the IRS is not the only government agency that will provide pressure to waive the privilege.

Next, I want to speak briefly about best practices, and then turn to possible new policies to consider. There are some things that may not be best practices but they are reactions to the current environment. They involve, in Ken Gideon's phrase, "suppression of candor." In our Survey, it was not a statistically significant number, but a few responders said they would not to seek outside written advice, except when absolutely necessary. I'm not sure that's good for the system. We also heard about obtaining written advice that is a so-called advocacy piece, done in the style of a brief. With a brief, you do have the obligation to cite an authority that may undermine the argument that you're making, but perhaps you don't have the obligation to describe issues that the other side might independently raise. Again that's not the best way to get it right.

Turning now to things that may well be best practices, Roger mentioned one already: consult your GAAP audit firm early and often, in ways that are respectful of their independence. While they cannot audit their own work, they do need time to assess things, just as you do. Last-minute surprises are not happy ones. Another best practice is to maintain appropriate records of the basis for the financial reporting of uncertain tax positions. Sometimes you will be able to do that in the form of a photocopy of clear published guidance that is directly on point with your issue. Unfortunately, most issues are not that clear. For some difficult issues, you will turn to the outside professional for the time-consuming, reflective, carefully written advice that you need but cannot perform on your own. There are also best practices for hanging on to the shreds of confidentiality that you may still have. One is correctly labeling a document contemporaneously with obtaining of advice. If you are obtaining the advice for the purpose of sharing it outside the scope of the privilege, you should not label it confidential and privileged because, if you share a document that looks like it was privileged, perhaps you have waived an otherwise good privilege on other documents involving the same subject matter. Sharing a document that clearly was never intended to be privileged should not create any waiver as to other documents. On the other hand, if you are obtaining a document that you do expect to stay privileged, it should be so labeled. The hard part comes during all the subsequent months and years, to be sure the document isn't shared outside the scope of the privilege. B. John Williams talked about keeping pieces of paper under lock and key. That's probably not practical in most instances, but if it is important to maintain the privilege, some sort of procedure needs to be thought about and implemented. You need to be alert, when there are requests for documents, as to whether produc-

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ing a document might waive a privilege. If you obtain a document with the idea of being able to assert a work product privilege, there should be contemporaneous documentation of your anticipation of litigation. It's also a good practice that to be selective in asserting anticipation of litigation. This is an area where pigs get fat and hogs get slaughtered. If you have a hundred memos in the file that you are anticipating litigation on the hundred issues in your work papers, that's going to undermine the credibility of the claim as to one that you really care about and do expect to litigate.

Turning now to policy implications, we may be in a situation where some things need fixing. It strikes me that an area of particular concern is where you have received tax advice that is privileged, but for the fact that you have shared it with your GAAP auditor. It might be a good thing for the system—for the taxpayer, the IRS, the audit relationship, and the investing public—that the privilege not be considered to be waived under those facts. There are several possible policy changes to think about here, none of which are particularly likely. One idea would be to develop a work-around with the blessing of the PCAOB and the audit profession—some way to document a tax position that does not necessitate sharing of privileged advice. Another possibility would be for the IRS to adopt an internal policy of restraint. That is, where documents are "almost privileged" in this way, the IRS would behave as if they really were privileged. Other approaches would require intervention of the Congress and perhaps state legislatures as well. A new law could say that the IRS cannot seek documents in this situation; or that no one, including private litigants, should be able to obtain such "almost privileged" documents. Such legislation could go further and say that supplying documents to a longer list of important regulators—the GAAP auditor, the IRS, the SEC, the Department of Justice, and perhaps others—would not constitute any waiver of privilege. The issue of access by private litigants brings in issues beyond the scope of what we're talking about, and it demonstrates how difficult it would be to enact any such legislation. For the time being, we just have to get over it because the realistic expectation of confidentiality of written tax advice is now down close to zero.

MS. PAULL: Thank you. Bill Gradison, I will start with you because I do have a series of questions from the audience. Several of them relate to your perspective on the progress that has been made on the quality of auditing. There are questions on what does it mean when you say you will open the window to inspection of findings regarding the 2004 domestic firm inspections? Are there different expectations with respect to the performance of the Big Four audit firms versus the next-tier firms? There is a general question with respect to tax services. You described the independent proposed rule that the PCAOB put out, but there is still concern that there may be a chilling effect on utilizing the auditor for tax services.

HON. GRADISON: With regard to the quality of audits, we've seen a lot of evidence that the quality of audits is being improved by the inspection process. It doesn't really show so much on the outside, but there are many circumstances in which the comment forms that go from our inspectors to an audit firm may result in the audit firm saying, "no, no, no, you don't understand, we don't agree with you," and yet when our auditors go back again, they find that the changes that they originally recommended were made. So, there's a lot of that going on.

With regard to the audit firms, there's a lot of really excellent work being done by firms, large and small. I think what to me is so striking in the large firms is the challenge which they have and we do, too, because we're working with them to try to assist them in improving audit quality. There's a great challenge of bringing the quality of all their audits up to the same level. Another way to say that is that the general quality of these audits, in my opinion, is very high, but not all of the engagements performed by that same audit firm are at that same level. So, this is not a question of asking for perfection. It is really a matter of encouraging, as much as anything, improvements of internal quality control within the firms so that they can—and this is a real challenge as they work, in some instances, with literally thousands of engagements—bring them up towards, if not actually to, the level of performance which they do in so many other instances.

With regard to the smaller firms, we have in our inspections so far emphasized the inspection of the smaller of the small firms. Keep in mind small firms are those that have a hundred or less issuer clients in a year. The reason for that was that the approach that our inspection force developed for working with initially the Big Four on the limited inspection basis in the fall of 2003, and then with the Big Eight beginning in 2004, really didn't fit the small firms. So, there was a lot of rethinking and then wanting to test in the field an inspection approach that would be appropriate for the smaller firms. As an example, to be more specific, a fair number of those have been done by saying, "Please send the work papers to us so that we could

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review them inhouse." I refer to it because of my tax background as a desk audit, but our folks don't like that term. They refer to it as a PCAOB-based audit, but the basic idea is to not always have to send a team out into the field with these small firms. They send the work papers in, let us review them and sometimes it does result in an on-the-spot inspection, but a substantial number of those small firms have been handled in that way. I would define a clean report as one in which we identified no elements that would be in either the public or the nonpublic quality control portion of the reports. To date, roughly 40 percent of all the small firm reports that we have done are clean in that respect. Now, this year, we'll be moving into the larger of the small firms, firms that may be doing 50, 60, 70 or more issuer audits in a year and we really haven't had as much experience in that as dealing with the ones that have much smaller numbers.

When I was referring to opening the door or window, all I was really trying to say is that we will be putting out, as our rules permit, what we call 4010 reports which, as I tried to indicate, would not identify either the auditor or the issuer but would give a sense of what we find and we'll see how those are written. I mean, they're being worked on right now. I would expect, for example, that there would be a section on taxes where you can look and see, okay, what kinds of things did the inspectors find in doing their field work, broken down by the Big Eight in one category and everybody else in the other. I truly don't know what will be in those. They're just being drafted. I obviously have read the reports because we had to approve them one by one, but I haven't tried to sit down and synthesize that with regard to the small firms. I actually did try a few weekends ago to go over all the comments and all the Big Eight reports on taxes and there's a great deal of variation, but they're not inconsistent with some of the comments that I've tried to work in at the outset of my remarks.

As I also tried to point out, I think that there are a great many instances in which having your audit firm be a tax advisor can be very positive. It's a matter really for the individual firm working through its audit committee to determine. There are some that feel that the net effect of our tax and independence rules may be to reduce, perhaps reduce the inclination of firms to look to their outside auditors for tax advice. That certainly, in my opinion, was not the intention of the rule and the rule hasn't even been put out for public comment by the SEC. So, it's premature, I think, to speculate on what its impact might be. I could understand that would be a concern and might happen, but I think it's kind of early to tell.

MS. PAULL: Thank you. Another set of questions go to the bigger picture of the swinging of the pendulum and the imperative to spend so much resources and incur so much costs in the quest to get it right and what the trade-offs are. The big question one person has asked is, whether the investing public is really going to benefit from all of this time and effort?

Another question notes that analysts are only interested in information on the effective tax rate. That is, analysts look to whether a company's effective tax rate is in the acceptable range for the industry and this company and why are the regulators insisting on so much more stuff?

I have another set of questions that notes that devoting all of the time and resources to this quest comes at the expense of the heart of the American sweet spot, which is creativity, and ends up having a chilling effect or stifling creativity. So, I open it up for discussion of these points.

HON. GRADISON: I'd like to start, if you don't mind. There certainly was a concern when Sarbanes-Oxley was first passed that it was having an effect on the risk-taking culture or attitude of senior management and boards of directors and there's some observers who feel that there was actual evidence that that was the case and it may well have been, but from where I sit, my personal view is that there was a learning curve involved and certainly the current status of the economy, the recovery that we're now seeing, the growth of jobs, innovation, which we're also concerned about, suggests that even if those problems did exist at one time, companies are working their way through it.

With regard to the impact, let me focus specifically on the internal controls rule because that's been the focal point of a lot of concern about costs. First off, every bit of evidence I see is that being new, the first-year cost was likely to be the peak and that a reduction should be anticipated. We were told in the roundtable which was held by the SEC and PCAOB in April of last year that the costs incurred on average were about 25 percent were the fees of the external auditor, about 25 percent for consultants and about 50 percent for costs in the corporation itself which has to do with, among other things, identifying, documenting and testing controls. There is great opportunity and some evidence that all three of those are being reduced in various proportions this year and we'll have a lot more information on this and look forward to getting it as we get into April for the larger calendar year accelerated filers. What does

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this mean to investors? That is a very difficult question to ask. The group in my opinion that we hear the least from in terms of just contacting us and sending in comment letters is the investor community, but maybe because I was a general partner of a New York Stock Exchange firm, I look at what the markets are saying, and I don't want to overstate this. We only have one year of experience, but what we have found is that the number of restatements has gone up very dramatically almost year by year. I don't know the proportion, but it's a very significant proportion that were restatements that were triggered by the internal control over financial reporting audit. In other words, these material weaknesses that led to restatements probably would not have been found by the traditional audit itself. So, I think that is of some significance.

There have been studies made of the market reaction when a company reports a material weakness of internal controls. The study, which I feel was the most complete look at companies in the filing period of last spring, measured market prices from six weeks before the announcement of the material weakness to one week after, and, on average, it suggested that there was about a four-percent penalty in market value for those who didn't pass the test as compared with those that did. I don't want to project that into the future, but there have been other studies of a more academic nature, which relate to the information that is important to investors, that suggests that there are some concerns in the investor community and that they actually are reflected in the prices that buyers and sellers negotiate in the marketplace.

MS. PAULL: Does anyone else want to contribute to this discussion?

MR. WILKINS: We did have a related discussion at breakfast this morning on the topic of uncertain tax positions. This area of accounting is said to have formerly been an art. It appears to be becoming a rather brutal item-by-item science. Is there a need to put a little more art back into the recipe? In particular, is it possible to have a respectable notion of a cushion for the category of things that you haven't identified yet but you know from experience will come up, without having it become a cookie jar? We have heard comments to the effect that the new approaches will cause the tax rate and earnings per share to jump around. Is that jumping around a good thing or a bad thing? When I say good or bad, I mean is it more reflective of reality or less reflective of reality in terms of what's important to the investor community?

HON. GRADISON: This actually came up in a somewhat different way in the discussion of materiality which we had with our Standing Advisory Group yesterday. It went along these lines, and I'm just barely trying to summarize my recollection of the discussion, that if the auditor goes in and finds the adjustment or release of reserves in a few isolated instances, that's one thing. If in the course of the audit, they find a whole pattern of steps all in one direction and a number of different estimates and reserve calculations, then there may, I stress the word may, be something else going on. So, how that actually works out in practice with an individual audit engagement is another matter, but since it does relate to materiality, I wanted to mention it. There are circumstances in which no individual item would look that big, but the changes year-by-year may all move in the same direction and that also is something that would be important for an auditor to examine, not only how are things breaking, you know, positive or negative in the year that's under examination, but how does this compare with prior years? As a matter of fact, it was a specific example mentioned by one of the people around the table, which was Waste Management, that the individual year-by-year changes in depreciation, as I recall it, weren't that dramatic until you looked at it over a period of years and it might have gotten quite a different picture.

MS. PAULL: Okay, thank you for your insights. I also have a question on who should have the primary responsibility for tax accounting. Historically, primary responsibility has been in the tax department, but I have a series of questions that are asking whether or not we have seen a shift in the involvement of other departments, for example to the CFO or the controller, in tax accounting matters. Should the primary responsibility actually be shifted from the tax department to another department? Whether or not some of these other groups that have now started to collaborate on tax accounting matters and whether or not they have the technical tax expertise to be able to deal with those issues.

MR. WYLIE: I think it's a question of what is best for your organization. Clearly, increased collaboration, especially between the accounting group and the tax group, is essential to being certain that tax accounting is precise and consistent with financial reporting. As was mentioned previously, accounting groups may not have the tax expertise to be able to do the calculations and understand the ramifications of the transactions that are flowing through the financials. In addition, we find that our auditors are looking not just to us but to the controller of the company to opine that the tax accounting is correct. So, we're going through an educational process where we may

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do most of the work, but the controller ultimately is signing off on points of particular interest.

MS. PAULL: Does anyone else wish to add to this discussion?

MR. REILLY: I can't remember the number from our Survey, but the majority in our Survey indicated that it was the tax function that had primary responsibility. But interestingly enough, there was a Tax Director Roundtable survey and they conducted two different surveys and when they surveyed the accounting group or the controller's group, the majority of that survey, or the plurality of the survey, indicated that the controller's group thought that they had primary responsibility. I've always felt that we had a shared responsibility for it and probably over the recent past, we've taken on more of it.

Interestingly enough, you know, when we were talking about the 404 and the burdens, I think we know we have to do these things now. So, I think now the companies will try to figure out how to do it more efficiently, and I think when it was first required, you were going to have to comply with the systems that were in place at that time and as companies adapt to this requirement, the systems will be designed to more efficiently gather that information.

There's another Tax Director Roundtable survey of a couple of years or last year and it listed the stakeholders that were involved in the development of financial IT systems and unfortunately the tax department was at the low end of the list, way behind marketing, way behind accounting, and I think now probably we have a better chance of saying, please make sure that when we design the systems, that it gives us the information we need for tax accounting and also tax compliance. I think there are some positives to take out of it.

MS. PAULL: Anyone else?

MR. WHEELER: I would just say that I think the tax accruals have been made with more specificity than other exposures that you find on your books. You have environmental exposures, patent infringement; you have worker's compensation, warranty. And all of those exposures are bookkept by the accounting department. You don't have patent lawyers and environmental lawyers and worker's comp lawyers managing the accrual. So, maybe to play the devil's advocate, why in the world would you think you'd need to have a tax lawyer handling the tax accounting? Maybe some of the problems we complain about, oh, well, the accounting firms scrutinize the tax reserves a lot more than they do the general litigation reserves or the warranty reserves or any other reserve. Well, maybe the reason for that is because we're the ones involved in preparing the reserve in the first place and we do it with such a level of detail that it invites the accounting firms to come in and scrutinize it with the same level of detail. If the level of detail wasn't there, you know, they're not going to look at it in that level. So, it may be something that we've brought on ourselves and I for one think accounting is accounting and an accountant should do it.

MS. PAULL: Next, we have a couple of questions about foreign operations. What might be material to a small foreign subsidiary is not really material to the operations as a whole worldwide, but we have seen some footfaults occurring in this area.

We also have a question with respect to disclosure. Many companies generally are not giving detailed disclosures for tax impacts on investments in foreign subsidiaries, saying it is too complicated and too many assumptions need to be made in order to practically calculate this. Some of the questions relate to pushing down more disclosure in the foreign subsidiaries, even if they are not a big piece of the picture, and whether or not they're seeing any trends in that area.

MR. WILKINS: This relates in part to how centralized the tax function is managed. I have heard in public and private sessions in the last couple of days that it probably is a good idea to withdraw some functions and responsibilities from local managers so that you're sure that you're on top of these issues. In the Crisis Management panel, we heard that, even if a particular tax exposure overseas is not material by itself, if there's any hint of an illegal act, the company can be put in the position of proving that it doesn't have a bigger problem by virtue of bad controls or pervasive bad practices. This can place financial reporting on hold until that question is resolved.

HON. GRADISON: I think, also, we should recognize within the audit firms that really about half a dozen firms are the majors in terms of working with issuers that have substantial international activities and the relationships within those firms are nowhere near as tight as it might seem when they have a common name. The foreign affiliates, for a lot of reasons, many of them as a matter of law or risk of liability and so forth, are quite independent, do not share profits with the home office, and therefore one of the quality control issues that we do look at through our inspections has to do with the relationship in an audit of, let's say, the U.S. firm, which is leading the audit, to its foreign affiliates and questions do arise at that level as well. I would hope that whatever summary

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we put out would be more specific than I just was, but I do want to just point out that that is one of the things that we would examine in terms of the quality control efforts of the domestic firm.

MS. PAULL: Roger, we have a question that would get back to the IRS's initiatives to bring large corporations more current, to speed up the exam time, and to get to the final tax payment quicker. We have a question from the audience that asks why you do not think the CAP program, which is one of the many tools for currency and was discussed in length yesterday, is the potential solution for rank and file companies?

MR. WHEELER: Let me answer it this way. I think I'd put this under the category of too many cooks in the kitchen. My mother had a lot of kids and she used to say, "I'll invite you all over for dinner and I'll feed you, and you can critique my food when it's over, but just don't be looking over my shoulder when I'm doing the cooking." I think that the process by which we make, in our tax departments (and it's different in all tax departments), but the process we go through to come up with a tax opinion and a tax decision, tax position, sometimes is not very pretty. And we go through a lot of back and forth and to-ing and fro-ing, and you really don't need to have the IRS there watching you go through that. I think, you want them to look at your answer right away, once you get it, but I don't think they need to be so involved in the process. I don't think you achieve currency that way.

Don't get me wrong. I'm not against the CAP program, and I think that it probably is one of a number of tools that can work very well and it may fit a particular situation perfectly, but I really have a reservation as to whether it would become the paradigm issue resolution or auditing technique for large complex taxpayers who may be pretty decentralized. It's probably good in a number of situations, but I think a lot of people can get there just as fast with a LIFE program or some of the other issue resolution programs.

MR. WILKINS: People with a litigation background would be shocked with the description that we heard of the CAP program, where the revenue agent comes in and says to the taxpayer, "Please tell me all your risks." That won't compute with certain people, and may put a limit on how universal this kind of program can get.

MS. PAULL: Yes. We had a long dialogue about this after the panel last night with one of our litigator panelists and he certainly was skeptical as to what this program might look like in the future as well. But as a pilot program, I think there are some initial successes that some companies have seen. So, I mean, it has a lot of promise. The whole concept of accelerating the exam time and getting to that final tax payment much quicker than we have seen in just five years ago is pretty important. I would say kind of one of the things I noticed when I was at the Joint Committee on Taxation, where, of course, we would review the refund cases and some of the largest deficiency cases, I did begin to see that trend start about five years ago, that there was a strong push within the IRS to try to resolve a lot of old cases. So, instead of seeing the cases that were 20 years old, we started to see those resolved. I even saw one case that involved several decades. If I revealed how many decades, the name of the taxpayer might become evident, which I can't do, but it was a stunning settlement to see.

Just a follow-up again—Roger, can you elaborate a little bit more on the collaboration with the audit firm, about including the audit firm earlier on, and whether you would engage them for certain kinds of tax services, but I think you had something else about that and it might be worth elaborating.

MR. WHEELER: What I said was that if you have a complicated tax situation that you are working on now, that the auditors will have to look at in a month or six weeks, you probably ought to get them involved in looking at it a little bit earlier. By "collaborating," I guess maybe that's not the best of words I could have used; "simultaneous" might have been better. But there's a lot of discussion of the information that will go back and forth and the sooner that starts the better. You're not going to get advice from your auditing firm if it's not legal to do it. I didn't suggest that you ought to test the waters in that regard at all.

HON. GRADISON: We are hearing increasingly concerns about the number of issues that are identified in an audit that an inspector kicked upstairs for review centrally within the audit firms. I haven't particularly heard taxes singled out or not singled out as an example, but that's not entirely surprising that that would be the case, and as a result, there's been some frustration on the part of some of the issuers that it takes as long as it does when an issue is identified and then it's being reviewed by the home office of the audit firm for a final decision to come down. Again, I repeat that's not intended to be a tax-specific comment because I really don't know about it in terms of just taxes.

MS. PAULL: I have another question for you, Bill, which I don't think you're going to be able to answer, but I will ask anyway. One of the interesting things

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that we have observed is that there is a lot more dialogue occurring since Sarbanes-Oxley. When you think about the effort to improve accounting for uncertain tax positions, we've seen a lot more dialogue involved in that process with a lot more input from a variety of different sources. One of the things the PCAOB has is the advisory group that meets quarterly with the PCAOB. The agenda for their meetings are posted on the PCAOB's web page. Firms have a lot of dialogue with the PCAOB and with the SEC. There's a lot more communication going on in these arenas. So, to get to your question, Bill, there is a follow-up question on the independence rules of the tax practice by audit firms. As part of the process to develop those rules, there was a roundtable that the PCAOB held with interested parties. It was a very long day discussing the issues, and then further dialogue occurred internally, with the IRS and the SEC. The question is do you think the SEC will adopt the proposed rules? Obviously you're not in a position to answer that question, but do you have any status report on the proposed rules?

HON. GRADISON: I'd be glad to comment, recognizing, as I said earlier, these are just my personal views. The rule was sent over to the SEC in July. They came back to us and indicated that there was one word that they wanted to have changed and we did that in the public meeting on November 30th of last year, substituting in one instance the word "contribute" for the word "cause" and so far as I know, there are no substantive issues that are remaining. My best understanding is that the documents that are necessary before that rule is formally put out in the Federal Register are being circulated among the five commissioners as we speak.

MS. PAULL: Thank you, Bill. One more question and then I think we will be out of time. This is a quick question for Bill Wilkins. Does the SEC, PCAOB or FASB have the right to force a public company to forego its common law right to attorney-client privilege as a condition to accessing the public securities market?

MR. WILKINS: I think they probably do as a practical matter. They're doing it by way of saying, "Would you like to waive the privilege or would you like not to have your financials certified?" With the Justice Department under the Thompson Memo, it is, "Would you like to waive the privilege or would you like us to proceed with our criminal indictment?" That isn't as voluntary a waiver as the victim would like, but it is a waiver, and I think it's effective.

MS. PAULL: Thank you, Bill and the rest of the panel. Thank you to everyone for your attention. We very much appreciate you being with us this afternoon.

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ENDNOTES

[*] This panel discussion took place at the Seventh Annual Tax Policy and Practice Symposium, *The Corporate Tax Practice in the Age of Transparency: A Path Forward,* held on February 9–10, 2006. The panelists' comments were edited, annotated and augmented prior to publication.

[1] Sarbanes-Oxley Act of 2002 (P.L. 107-204).

[2] Novak Marketing Inc., Market Research Study, Tax Council Policy Institute, *The Corporate Tax Practice in the Age of Transparency: A Path Forward* (Feb. 3, 2006).

[3] Video of Donald T. Nicolaisen, former Chief Accountant of the U.S. Securities and Exchange Commission, speech given at the Fifth Annual Tax Policy and Practice Symposium, *The Corporate Tax Practice: Responding to the New Challenges of a Changing Landscape,* held on February 11–12, 2004.

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