The View from Above—Reactions of Audit Committees to Tax Risks

*By John S. Levin, Kenneth R. Petrini, Lawrence S. Smith and Thomas W. White**

MR. WHITE: Let me begin by introducing my distinguished co-panelists. First is John Levin, Senior Research Director of the Tax Director Roundtable, which I understand many of you know very well. It is an organization that provides best practices research, benchmarking and executive education services to tax department heads and their staffs. Before joining the Roundtable, John was a practicing tax lawyer in various capacities, both in-house and in a law firm. Next is Larry Smith. Larry is the Executive Vice President and Co-Chief Financial Officer of Comcast. He's also a member of the audit committee of Air Products. Larry joined Comcast in 1988 where he has held various finance and administrative functions. Prior to that, he was the CFO of Avanta Corporation, and prior to that, he was with Arthur Andersen for about 18 years, where he was a tax partner. Finally, we have with us Ken Petrini, Vice President of Taxes at Air Products and Chemical, Inc. Ken has been with Air Products for about 20 years, as a tax attorney, and in 1997 he assumed his current position as head of the Global Tax function.

We're looking forward to our discussion. Let me open briefly by following up on one of the things we heard yesterday at the privilege panel, *The Privilege Battleground—Responding to Challenges to the Traditional Legal Privileges*. Ryan Burdeno of PricewaterhouseCoopers was the auditor on the panel, and one of the things he said that I found noteworthy was that from the auditor's point of view, tax is a high-risk audit area. That's because, among other things, tax is potentially 30 to 40 percent of net income and because often there is a big disparity between when tax charges are accrued and when the cash tax is actually paid. Tax is something the auditors look at particularly closely.

So, what we want to talk about today is: How does this translate at the top? How does the audit committee, which has ultimate oversight responsibility, at least on behalf of the Board, for the financial statements of the company, consider tax issues? What is the best way, from the point of view of the internal tax function, to make sure that the audit committee is getting the information it needs and is appropriately considering tax matters?

With that, I'd like to turn it over to John Levin, who is going to make some opening remarks.

MR. LEVIN: Good morning. I am very pleased to have the opportunity to speak with you today about the communications and interactions between Heads of Tax and their audit committees about tax risks.

At the Roundtable, I have the privilege of working with over 300 heads of corporate tax functions and their teams. The opportunity to work with these many seasoned and thoughtful tax professionals, a number of whom are here with us this morning, as well as their counterparts working on other corporate staffs and audit committees, gives us a broad

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perspective on both the nature of communications between Heads of Tax and their audit committees, and how those interactions are evolving.

Tax and Audit Committees' Respective Roles. I would like to begin the substance of my remarks with an articulation of the responsibilities that are shouldered by the Head of Tax and his or her staff, on the one hand, and members of the audit committee on the other. The nature of each of their respective responsibilities has significant implications for the nature of the interactions, and the breadth of communications between them.

Corporate tax departments, as everyone in this room certainly knows, are charged with the hands-on management of the corporate tax function. That overarching responsibility encompasses making technical judgments about the proper interpretation and application of tax laws and the financial reporting of income taxes; implementing those judgments in matters of tax compliance, planning, controversy and income tax accounting; instituting and managing tax work processes; establishing judgments about tax-related risks—both upside and downside—and the management of both; working with businesses and other corporate staff groups; and keeping those with supervisory responsibility over the tax function informed about material matters—especially material tax risks—and keeping themselves attuned to their company's risk tolerances. Just to name a few.

Now how about the audit committee? I would like to start here with the definition provided in Section 2 of the Sarbanes-Oxley Act.[1] An audit committee is "[a] committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and the audits of financial statements of the issuer." Section 301 of Sarbanes-Oxley also specifically charges the audit committee with direct responsibility for hiring and overseeing the external auditor.

In addition to those statutory mandates, other regulatory sources, including New York Stock Exchange and NASDAQ listing requirements, among others, impose on Boards generally, and on audit committees in particular, responsibility for establishing policies for, and ensuring the effective management of, corporate risks. This broader mandate is increasingly entrenched in audit committee charters. And while it is often unstated in those charters, Tax risks are frequently cited as being within the scope of audit committees' supervisory responsibilities.

State corporate laws also impose on Board and audit committee members fiduciary obligations to shareholders. All of these mandates stretch across the activities of business units, and of corporate staffs. All in all, these extensive responsibilities give rise to an extremely broad mandate for audit committees, one that requires careful apportionment of audit committee capacity across the full range of responsibilities and corporate actors.

Fundamentally, though, it is important to keep in mind that the obligations of members of corporate boards are supervisory in nature, not managerial. Differentiating between the two—supervision and management—in today's environment can be extremely challenging, especially when so many rules of the game are in flux, as they are today.

I have reviewed the respective responsibilities of Heads of Tax and audit committees because the interactions between them must be structured to enable each of them to fulfill their respective obligations. Based on our research, including numerous discussions with Heads of Tax and audit committee members, we believe that interactions and communications between them should be revised to provide each with better information and more effective tools for discharging those obligations.

Typical Tax Communication with Audit Committees. Before adoption of Sarbanes-Oxley in 2002, Tax's interactions with the audit committee were in most instances quite limited. The Head of Tax, or sometimes the CFO to whom the head of tax reported, would meet with the audit committee once each year to discuss tax matters, typically shortly after the year-end to review the provision and material reserves, and only at an extremely high altitude. That was simply all that was required. On occasion, some Heads of Tax would also meet with the audit committee to review, again from 30,000 feet, major transactions or material controversies that entailed significant risk exposures.

In the first years of the 21st century, however, perceptions of tax-related risk from the SEC, FASB, external auditors and senior corporate management increased significantly in the aftermath of corporate governance and tax shelter scandals. This increase in the perceived magnitude of tax-related risks, especially financial reporting and reputational risks, has wrought changes in senior management's concerns about how tax attends to its business. A significant factor in this changing perception of tax-related risks is the fact that in 2005, 22 percent of all material weaknesses from companies with revenue in excess of $500 million originated in the tax function. As a result of these developments, many Heads of Tax now meet with their audit committees more frequently than once each year, in some cases considerably more frequently. External auditors' increased attention to the accuracy of income tax accounting, including the computation of deferred tax balances, the determination of tax reserves and related disclosures, is focusing more audit committee attention on the tax function. We also understand from our colleagues who study trends and leading practices in the Internal Audit function, that these factors will likely focus even greater attention on tax from both internal audit and the audit committee in the coming year.

The historical approach to interacting with the audit committee I have just described is, for the most part, a system of exception-based reporting. It has the advantage of getting certain key tax-related information, including information about significant tax risks, before the supervisory gaze of the audit committee. While this approach does preserve the audit committee's ability to allocate its time and attention to other risks of enterprise level significance, it may come at a potentially material cost. The exception-based reporting system provides audit committees with only very limited background and context for the information typically provided in exception-based reporting. Yet it is precisely that background and context that is vital to effective decision-making and supervision. Most information about "normal" transactions, the risks that are routinely and advertently assumed, and the policies by which tax decisions are made is in most cases *not* provided, even though the additional information is often necessary to the formulation of well-considered supervisory judgments about which risks may be prudently assumed, and which not.

Enhanced Communication of Context. While most Heads of Tax's contacts and communication with their audit committees remain models of exception-based reporting, other thoughtful Heads of Tax have taken a somewhat different approach. This alternative approach accepts the notion that reporting on exceptions—reserves, major transactions with the greatest potential impact on corporate performance—must be presented to and discussed with the audit committee. But proponents of this alternative also believe that exception-based reporting is not enough. Their conclusion is supported by data showing that only 33 percent of Heads of Tax agree completely that their audit committee has adequate appreciation of the potential impact of tax on their company's financial reporting.

This alternative approach, which enhances contextual communication, accomplishes two things. First, it expands the scope of information shared by tax with the audit committee to include information about the overall tax posture assumed by the tax department, and its major processes and decision rules, in order to provide a baseline against which the exceptions, the extraordinary risks and transactions, can be more meaningfully evaluated. And second, it enhances the ongoing dialogue between tax and the audit committee, a process that will over time promote the development of a shared and increasingly explicit understand of corporate risk tolerances among tax, the CFO and the audit committee.

We have seen these benefits achieved at a relatively small number of companies, and the benefits can be significant. For example, shared expectations enable tax departments to avoid stepping outside the ordinarily implicit and indistinct risk tolerances of their companies, and thus contribute to avoiding risks that may appear acceptable from a parochial perspective but inadvisable from the perspective of the enterprise as a whole.

We believe that this approach, based on enhanced information sharing and dialogue, can lead to more effective tax risk management for the enterprises we serve. We commend this alternative approach to your consideration. Thank you.

MR. WHITE: Thanks, John. I would like to follow up on John's point with a brief discussion of the legal foundations of the audit committee's function. I have included in the Symposium materials what we call a sample or model audit committee charter for an NYSE–listed company. It's WilmerHale's best form of charter. I think it is pretty comprehensive, but it is seven pages long and the most notable thing about it, among other things, is it never uses the word "tax" once. The charter does have a number of more general statements that I think define the audit committee's responsibilities and would definitely apply to the tax part of the financial statements. These include things like:

- responsibility for overseeing the integrity of the company's financial statements;
- oversight over compliance with legal and regulatory matters;
- oversight over internal control over financial reporting, disclosure controls and procedures, and business conduct and ethics policies; and
- the wide-open category of discussing—and it uses the word "discussing" advisedly—policies with respect to risk management and risk assessment.

At the same time, it is important to note that in this policy there is a long paragraph that attempts to circumscribe the scope of the audit committee's responsibilities. This paragraph is largely directed at protecting the audit committee members from extra liability due to the substantial functions that they perform. It says that the committee shall discharge its responsibility and shall assess information provided by management and the independent auditors based on its own business judgment. This is an importation of the so-called business judgment standard. It makes it clear that it is up to the audit committee members to decide what in their own expert business judgment is the appropriate level of review and the appropriate actions that they should take. The charter also makes clear, of course, that the responsibility for the financial statements rests with management and the responsibility for auditing those financial statements and reviewing those financial statements rests with the auditors.

It is clear from this policy that the audit committee is not supposed to engage in actual reporting or accounting, and it would be impossible for them to do so. Nonetheless, this is a pretty long list of very general requirements and it covers a lot of ground. As we all know, and I'm sure Larry can attest, this has led to a substantial increase in the amount of time that audit committee members have to devote to the audit committee process generally. Certainly one question that arises is: How much time and resources can any committee devote to particular parts of its function, like tax, when it has to do big picture things, like picking auditors, assessing the effectiveness of auditors, and so forth?

So, with that in mind, the other thing I would say is that it is very useful to review the Survey[2] results on the audit committees. They reveal some interesting differences in how various companies' audit committees approach the tax function. I think that's why it is useful to have this conversation because there is certainly no uniform practice as yet. With that, Larry, I turn it over to you to address, from the point of view of the audit committee member but also in your CFO capacity, what should the role of the tax director be with respect to an audit committee? What is your experience in terms of how much input tax should have with the audit committee?

MR. SMITH: Thank you, Tom. It's kind of interesting. These pendulums seem to have wide swings and obviously today we're on one end of the pendulum. As a practical matter, in my experiences both at Air Products and Comcast—and that's pretty much the limit; it's been 20 years since I was in public accounting—I think it almost has to be on an exception basis. I think it's inconceivable that an audit committee of any sizable company that has complex tax problems can do anything more than hear the issues once a year. If there is nothing going on, that in my mind would probably be adequate. If some major issue occurs, then maybe it should be more often than that. Obviously as part of the audit committee, every quarter when you're doing the K or the Q, you hear about the effective rate. So you do have a conversation about the tax provision for that quarter and you get something of an update. If there was a wild swing because something was going wrong and a big reserve was being set up, you would know about it.

As a practical matter, very, very few audit committee members can really digest and understand many of the issues that are so complicated and so arcane in many cases. In the case of Comcast, we've been a very active company in both acquisitions and in terms of numbers of assets that we have created and then sold. We have had a number of divestitures and the large acquisition of AT&T Broadband, where we did inherit a bunch of tax liabilities. In all those cases, we spent a lot of time, not with the audit committee in particular, but with the full board. That is because taxes are a very significant component of a transaction generally, whether it's a 355 or it's a 1031 or it's a whole series of transactions. The reality is we go through all that in great detail. At least they have been told about it. At that time also, we will have Davis Polk, who does most of our external tax legal work, with us in that conversation. As a result, the whole board has generally been apprised of what the issues are in this particular transaction. We do not see a need to reiterate them at every audit committee meeting or even annually, unless something has gone awry or some issue has arisen that would make our position different.

So, my thinking is that the audit committee has all those responsibilities and the audit committee's entitled to anything they want to see. Most of the members of the committee will not be able to really understand the issues, and it is very dangerous, I think, for the company to take the management out of the hands of the management and put it in the hands of the audit committee. I sit on two sides of this, but certainly from where I sit at Comcast, the last thing I would want would be for the audit committee to give me guidelines as to what I have to do or cannot do. I am more than happy to discuss anything they want to discuss, but they should not try to take any judgment out of the hands of management and management's advisors. In my view, if they tried to do that, they are really saying that they do not trust management and, if so, they should replace management.

MR. WHITE: Ken, let me ask you for your perspective as the internal tax director. To what extent do you think information should go up and what kind of guidance do you look for from the audit committee? Do you look for guidance from the audit committee as opposed to just hoping that they are informed?

MR. PETRINI: Actually, in my case, it's been a tremendous change from two years ago. So, if there's one thing that I took away from this Symposium two years ago, in fact, it's in this area. When you saw the video yesterday of Don Nicolaisen,[3] if it was a wider shot, you would have seen that I was actually sitting next to him when he finally sat down after his talk, and it was something new to hear, an idea that he had thrown out during his presentation, that tax directors should go before the audit committee on an annual basis, if not more often. It's something that I had never thought of before that and another member of the panel that day had indicated that, in fact, in his company they did that. So, as soon as I got back to the office, I contacted him for advice on exactly what they did and also talked to the CFO and, to show how things have changed in the last two years, we are now part annually of the schedule for the audit committee and each year go before them with a presentation. I do think that it's an important part of what I do, and I don't know if there's a best practice on how you present it to the audit committee, but I wanted to share what we do because I do think it works and I think that Larry at least is satisfied with it and it's seemed to work for two years. It's also a presentation that we give to each new board member as they come on the board as part of the finance review that our CFO does, the corporate governance review that they do with the new board members when they come on. Tax actually sits down and reviews much of the same information with each board member, so they'll have some background, because when you think of it, your tax charge is a very high number and I got some strange looks as we were meeting just before when I said the one thing I'm sure about my tax number is that it's wrong.

MR. WHITE: Your auditors aren't here today, I hope.

MR. PETRINI: Well, I'll tell them the same thing, but the one thing we know is that the biggest component of that number, the change from year to year, is what I've put in and taken out of my reserves and I know that since it's a judgment, that my actual experience with the audits will be different than what I've estimated and you see that all the time when companies complete an audit and then release a significant reserve or they have to take a charge because they haven't reserved well enough. I think it's very seldom that somebody gets through a multiyear federal tax audit and has hit their reserve right on the head. If you're able to do that, I don't think you have many worries, but I think in most cases, you've either over or under-reserved because you have either underestimated or overestimated the strength of the IRS's argument or even whether they would challenge an issue.

So, with that in mind, I think it's very important that the audit committee, just as they review litigation matters and the potential exposures the company might have, understand the parameters that we're working in when setting that tax reserve because we've set the reserve as a best guess within a wide range, which is also something that Nicolaisen referred to. The absolute exposure, also your judgment, what they pay me for is my judgment, but they need to also understand what the range is. So, we go through a written submission to the audit committee, followed by a maximum of 10 minutes of questions, and I got out in five minutes last year. So that worked well. We start off with a recitation of our principles. We don't seek absolute guidance as to what level of opinion we need or what types of risks we need to avoid, but we do set forth what our principles are, the main principle being you achieve the lowest effective tax rate while maintaining the corporate reputation. It's a principle everybody can get their arms around. It leaves everybody with enough flexibility to act and you can then decide afterwards whether a specific transaction was within or without that principle.

After going through the principles, we do review with them where our effective tax rate has come from because I think it's an important part of the review they have to go through during the year, reviewing quarterly earnings release, to understand exactly where this is coming from, what are the major factors affecting it. It's also a great way to advertise the effectiveness of your tax department because a large part of that hopefully are actions that you've taken, but then an important part is reviewing the build-up of the reserves and we do give them the absolute exposure for our reserves and go through major reserve items. Most of those items are items that the IRS is going to know about. There are items that you have disclosed to them in the opening conference.

The one thing I think is important to realize is that probably anything that you review up to that point with the audit committee is going to end up being referred to in the minutes and since one of the first IDRs the IRS always provides in their audits is a request for minutes of the board and its committees, whatever you're preparing for that annual review with the audit committee, you probably need to prepare with a view towards the IRS seeing it. So, we put in the maximum number as far as the written materials. We will give them an oral presentation as to our understanding and our belief as to the exposure within those parameters, but we're really not giving the IRS anything on an issue they're going to raise anyway to tell them the maximum amount of tax that's at risk for that issue because an IRS auditor is able to figure that out pretty easily. We go through that with them and then go through the major planning ideas that we've gone through during the year and the major components that varied from the effective tax rate, and I think by doing that, what we are attempting to do and hopefully what we are doing is putting the audit committee in the position where they are informed. So that two or three years later when that audit finally resolves and there is a release or there is a charge, the audit committee has some understanding as to what's been going on and it's something they are prepared for and they have been informed as to the parameters that you were working in. They're also informed as to the basis of your estimates. So that's been a major change for us because we always operated under the approach that you kept tax away from the board. If tax designed a transaction, you did everything you could to find a way to approve it at the CEO level and not have to go to the board because you never wanted a tax issue appearing in the minutes. I think those days are gone.

MR. WHITE: Why is that?

MR. PETRINI: There was a feeling that you never wanted the IRS, while they're reviewing the minutes, to see the tax department had presented anything because if the tax department had presented something to the board, it must have been a tax-motivated transaction. So, we kept the tax department and tax transactions away from the board because you didn't want to have that visibility as to your tax planning.

MR. SMITH: Couldn't you just keep it out of the minutes?

MR. PETRINI: Probably. Larry, you've operated around our organization long enough to know that there has always been this sensitivity to try to keep those kind of things hidden and that is the way we operated. I think that will be changing and so I think for those who are not currently seeing their audit committee on an annual basis, it's something you really should discuss internally within your companies because I think it's good both for you and also for the audit committee in performing their function.

MR. WHITE: This raises a lot of interesting follow-up questions. I'll digress a moment and say that the question of minutes is a bit like some of the privilege issues we talked about yesterday. The traditional standard of minutes was to say as little as possible. For example: "The board (or the audit committee) received a presentation from Mr. Petrini on tax issues." Period. Maybe that's still the right thing to do, but increasingly the absence of detail in minutes may be used to draw an inference that there wasn't a discussion or the directors did not get full information. But I digress.

I will turn it back to both of you to ask the question: Ken, when you give your 10-minute report—people may think that that sounds like a pretty short period, but for most audit committees, given what's on their agenda, that's not an unreasonable amount of time—do you see their eyes glazing over (except for Larry, of course)? Or do you feel that the audit committee is getting the message and responding appropriately? Larry, I would ask the flip side of the question, which is, are you satisfied as an audit committee member with the kind of information, the quantity and quality of information, that you are receiving?

MR. PETRINI: Even if Larry wasn't sitting next to me, I'd have to say this: I think our audit committee actually has an unusually strong finance background. So, while there may be some eyes glazing over, those are usually the people from internal audit and the people taking the minutes as opposed to the members of the audit committee, but I think we are blessed with an audit committee that does understand the tax issues.

MR. SMITH: I would agree. Obviously I am satisfied or I would do something about it. I think Ken does a great job and, like he said, when you come on the board, you get briefed. You get as much detail as you want, and then each quarter, there is an ongoing discussion of matters that are of importance to any litigation. Of course, there hasn't been any real tax litigation to talk about, but each quarter, you talk about litigation issues, and if there was a tax matter there, we would talk about it. So, I think the members are certainly well informed, and I don't see any issue.

MR. WHITE: Here's a question that I'll throw open to the whole panel. One thing that John raised was the degree to which the audit committee can or should impose or suggest parameters on the scope of tax positions or types of transactions that the company should engage in. As an audit committee of the board, would you believe that a tax department that took only "should" level positions was delivering appropriate value to the shareholders? I think that raises the broader questions of (1) should the audit committee be imposing guidelines and (2) is this an appropriate guideline?

MR. SMITH: I would suggest that they are depriving the shareholders of value. The real job of the board of directors is to get the maximum value from that company for its shareholders. To take a position like that would be, in my mind, completely wrong. I'll give you an example outside of the tax area from Air Products in the context of derivatives. Would you say that you should never do a derivative that is not a perfect hedge? Well, in Air Products' case, they have to hedge things that aren't hedgeable, where there is no absolute other side. You have to create synthetic hedges. We as the audit committee said, "Wait a minute, you can't just go do that." We put parameters around it and created a policy that basically said it is fine to do a derivative, but we want to see it before it is done. That's all. You might do the same thing with taxes. You might tell management that if it is going to take positions that could be embarrassing to the company, in some way negative to the institution or potentially a legal liability to the directors, then you should present those positions to the committee. But you certainly should never say the company cannot do them.

MR. WHITE: John, what is your perspective?

MR. LEVIN: My perspective is actually quite similar. I think it's dangerous to prescribe specific standards because we know that the business decisions we make are fact specific and context specific, and so to have strict prescriptive rules will be either problematic or unhelpful. The only standards that you can make are the ones that you ought not need to make. Rather, what's important is to make sure that tax, the audit committee and other constituencies within the company are essentially singing from the same song sheet. They understand each other, they understand the business as a whole, and to the extent possible, drilling down a little deeper, understand the parameters within which different functions work, so that tax can be free to do what has always been the source of value for the company exercise its judgment prudently within broad parameters. So, parameters, yes; prescriptions, no.

MR. WHITE: I know from some of my experience that audit committees have become more sensitive to tax issues because some companies have engaged in the past in what might be called "tax-motivated," "tax-advantaged," "tax-structured" or "tax-sheltered" transactions that have unfortunately come back to bite them. These resulted in litigation with the IRS and significant charges which may or may not have been reserved for. From an audit committee perspective, it may not be surprising that the committee would say, "We sure do not want to get into that position again." But it isn't just the company that actually had the experience that is concerned, because other companies are looking at what has happened and the bad publicity as well as potential liability. Do you see increased pressure from the audit committee to try to put limits on tax activities to make sure that the company doesn't do something that will backfire?

MR. PETRINI: I think you've put two questions together. Back to the should opinion, if you're going to set a standard, setting a standard as "should" makes very little business sense because, if anything, okay, "more likely than not," but probably even below that, "substantial authority," but setting a "should" opinion for the threshold of doing something is in effect giving the IRS the benefit of the odds. You're giving them the house money, the difference between "more likely than not" and "should," that 20 or 25 percent. That can be a lot of money. I think even saying that you shouldn't do anything unless you have authority for it, I think you also have to take into account—and I'm not talking about audit roulette here as much as I'm talking about administrative practice—yYou have to take into effect the risk of detection and the realities of the world. If we were to poll the audience, there's probably one or two tax directors out there who expense items which technically should be capitalized, who have an expense limit that, because internally the books expense everything under $1,000 or $2,000, and they follow the books and have reached agreement with the IRS that it's just a timing item and it's the kind of thing that they don't worry about. In fact, there are probably one or two people out there who have entered into agreements with the IRS in the audit to ignore items below a certain threshold. So, I think we all do things every day which technically we know would not rise to the level even of "more likely than not," but it's just the administrative way the tax is done, but once you put that policy into force, I would suggest you have to follow it. I think the key is perhaps something that John said. You avoid those things that are illegal. You want to worry about the corporate reputation. Even trying to avoid things which are listed transactions or tax shelters or any other term you want to put on it, first of all, many times when you enter into a transaction, it's not yet listed. So, are you retroactively violating the policy when it later gets listed, and just because it's been listed doesn't mean that it's wrong. And the example I'll give is there is guidance out there from the IRS on how you can validly make a contribution of intellectual property and there's a revenue ruling that tells you how to do it. Well, their latest penalty notice earlier this year or late last year listed contributions of intellectual property as one of their listed transactions. It's not, but it's something that was always—fundamentally, you can do it. What you can't do is overvalue the property. Is that the kind of transaction that a tax department should not enter into because the IRS decides that they're going to list it and take a position which is contrary to law? I think that's why you need the flexibility and less than rigid guidelines because otherwise you end up in a situation where most companies were following that kind of an edict. There had to be a "should" opinion or you had to avoid a listed transaction. It would be very easy for the Service to win every position they wanted simply by listing it.

MR. WHITE: Have you received comments or are you aware of situations where the audit committee says, "Okay, that's all well and good, but do you have a legal opinion to support it?" Or, "What does your counsel say?"

MR. SMITH: In our case, like I said earlier, we have that conversation when we enter the transaction, not after the fact. We have a full board discussion at that time as to how good the position the company is claiming and what are the economics. In other words, we have a transaction and we think there are $300 million of tax benefits associated with it, but there's only a 50/50 chance of that being right. So, we seek to handicap the transaction. We see a lot more of this in that context than we do at the audit committee.

I should say that our audit committee chairman at Comcast is Mike Cook, who was the head of Deloitte and Touche for a number of years. Mike is the preeminent audit committee chairman. He is a professional board member at this point, he is really up on these issues. He has never suggested that the committee should put any parameters around us.

MR. WHITE: Let's talk a little bit more and then we'll go to questions. If the exposure draft on uncertain tax positions becomes effective, how will that affect the attention of audit committees and the presentations and involvement that the tax department would have with the audit committee? Ken, maybe you might take that one first.

MR. PETRINI: I guess the biggest concern there is the same concern that we have in general with the exposure draft, is that with the idea that even with a "more likely than not" standard but also with the idea that you can't take into account administrative practice, detection risk, whatever you want to call it, and the fact that every item needs to be one that you can go out there and you can substantiate, I think we're going to see a lot more variability, some wild swings in some numbers as far as the absolute amount of the reserve perhaps being higher than they were in the past. So, I think as an initial matter, there will be an education period going to need to take place as to why the tax rate, the tax reserves after the exposure draft, aren't necessarily comparable to what they were before, and I think we will probably have a secondary discussion that we haven't had in the past and that is, okay, this is what we have to book, but what is the trend rate? I think we're going to be spending more time trying to normalize the tax rate for our board and probably for analysts as well, so they can understand where things are in a real sense as opposed to necessarily where they are in the more sawtooth environment.

MR. LEVIN: That's exactly right. The only thing I would add is that there will be a period of transition as we and our audit committee members get accustomed to the operation and the effects of the new standard. It will be a transition period and after that, the numbers will change, but the process will run its course. I don't see any other real significant effects, given the FASB's backing off the "probable" standard, which would have caused much more radical swings in rate and uncertainty about the validity and the meaning of financial statements.

MR. SMITH: The real risk, of course, is that you might not do a transaction because of the effect it would have. You would have to book more reserves or you would have to increase your effective rate beyond what it really should be. So you may say, "Let's not do the transaction," which is a crazy nonsensical answer, but that is what will happen. We recently had a situation where we restructured a leveraged lease that we got from the AT&T transaction. The way it was restructured, we have some tax we will have to pay 30 years from now. On an NPV basis, it made all the sense in the world, but the accountants said there is no more book income, you have to book all the taxes today. There's no NPV concept in tax accounting. So we had a big hit to our taxes in that quarter, but we did it anyway. Unless you are of that kind of mindset, there will be transactions that won't be done. A lot of companies are so obsessed with EPS and everything absolutely as anticipated, that there will be transactions that will not be done, which in my mind is just a sin.

MR. LEVIN: Someone suggested that was one of the motivations for proposing the "probable" standard in the first place.

MR. WHITE: Let me go to some of the questions we've got here. I'll take them more or less in order. I guess this is directed to you, Ken: At Air Products, does the internal audit department review the tax department?

MR. PETRINI: No, our tax calculation isn't reviewed by internal audit. We work very closely with the external auditors, but to my knowledge, we've never been reviewed by internal audit.

MR. WHITE: Larry, does your internal audit get involved in tax matters?

MR. SMITH: Not currently. I mean no disrespect to our internal auditors. Internal audit is not involved in the provision or the numbers as much as whether the documentation is correct and so forth and so on for 404.

MR. PETRINI: We have a separate 404 office, project office, and they in fact run the 404 test on those things which are high risk. We self-test on those things which are medium or low risk.

MR. WHITE: What is your experience with the level of involvement of the audit committee in connection with the approval of the external audit firm rendering tax advice? Is it rubber stamp or real review? That's a loaded question!

MR. PETRINI: We actually went through a change in auditor which had audit committee members leading the team. The audit committee also then after they did that, the auditor that we brought in happened to be the same firm I was using for expatriate tax advice, and at the same meeting which they approved the new auditor, they also told me to find a new expatriate tax service provider. They also told me to stop using the external auditor for substantial tax advice. So, they were very active in having us go away from the audit firm as our tax advisor. I don't think there was any involvement in actually picking the successor firm, although, you know, there were only three candidates at that point.

MR. WHITE: Maybe I should elaborate on this a little bit. This is an auditor independence issue, and as you all may know, under the Sarbanes-Oxley rules, generally speaking, most so-called nonaudit services are prohibited for your external audit firm. There has always been an exception for tax services. Even with respect to the permitted tax services, there is a requirement that the audit committee approve any nonaudit services pretty much on a case-by-case basis, though you can set up some parameters and so give advance approval for some kinds of services, up to some numerical levels. I think this question is, when somebody comes to the audit committee and says, will you approve this particular project, does the audit committee actually ask questions and go into it or does it just say, "Fine, do it"? Now, Ken's answer basically is what many companies have in fact done in response to all of this, which is to say we don't want to get anywhere near this issue. There has been a lot of criticism of companies that use their auditors for nonaudit services. Therefore, audit committees instruct the company to not use their external auditor for most tax services, and I guess that's more or less Ken's company's experience.

MR. PETRINI: While we were still using the audit firm for tax services, every engagement of them globally, I think of any size, was reviewed and approved by the chairman of the audit committee. We had adopted the policy of having the chairman approve it and it was not a rubber stamp and there was often pushback and some items were actually deemed to be too large and we went to other service providers.

MR. SMITH: We don't have an absolute prohibition at Comcast like Air Products does, but it is not a rubber stamp either. Each request to do tax services is evaluated on its merits, whether the auditor is truly independent and whether it would have any effect on the financial reporting. It is certainly discussed each time. We only have a couple of issues a year.

MR. LEVIN: I'd also just like to add that in our conversations with Tax Director Roundtable members on this topic, a plurality, maybe 40 percent of companies, do have an absolute prohibition on tax services from their audit firm, but beyond that, we have heard on a number of occasions that while it is permitted, the work that you have to do to get approval is so substantial that it's not worth it, unless there is some specific person who has a specific history or expertise that that's the person that they absolutely need to use. That would suggest that there is substance to the review.

MR. WHITE: Of course, the PCAOB has adopted rules relating to this subject as well. There have been two categories of tax services at issue. One is the sale of tax shelters and products like that, which is pretty much verboten under the PCAOB rules and was probably a bad idea at any time. More regular, routine or tax planning-type services relating to expatriates, and things like that, are not prohibited. The whole focus on the issue by the PCAOB puts more pressure on companies to think about going in a different direction.

Next question: The Survey indicates that 80 percent of the companies that settled audits in the last two years released tax reserves, suggesting a tendency to over-accrue for tax exposures. Are audit committee members equally concerned about an over-accrued tax reserve and posturing for any surprises?

MR. SMITH: I would say not. I don't think there is a tremendous concern over over-reserving. We have always been very, very conservative and my sense is Air Products has been as well. I would much rather be that way and so would everyone. We have never had an exposure or an issue from the accounting firm that we have over-reserved on taxes. We have had it on several other issues that were not tax-related, but we have never had that issue on taxes.

MR. WHITE: I think that's all the questions we have, and we have a couple of minutes left, so maybe I will turn it back to John and the rest of the panel for any concluding thoughts you may have.

MR. LEVIN: I think that this is clearly an area that is still emerging to a large degree, as everyone feels their way forward in the new regulatory and reputational climate. Ken mentioned reputation risk earlier, and it is certainly something that a lot of people will spend a lot of time worrying about. If you have a single very large shareholder, that probably contributes to it, but this is going to be something just to work through from a very pragmatic level or pragmatic perspective, keeping in mind the very significant regulatory changes that have been infused into this entire set of issues.

MR. PETRINI: My guess is we will be sitting here again in a few years probably talking about the same subjects and talking about how much easier it was back in 2006.

MR. WHITE: Perhaps on that note, we should wrap up. I think this has been a very interesting discussion. Hopefully it's been illuminating for all of you. Thank you very much.

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.