
BRIEFING PAPER

PROPOSED ETHICS AND INDEPENDENCE RULES CONCERNING INDEPENDENCE, TAX SERVICES, AND CONTINGENT FEES

DECEMBER 14, 2004 PUBLIC MEETING OF THE BOARD

At its public meeting on December 14, 2004, the Public Company Accounting Oversight Board will consider whether to propose, and seek comment on, certain ethics and independence rules. This briefing paper highlights the more significant aspects of the proposed rules and a proposed Board release to accompany those proposed rules.

Background

Section 103(a) of the Sarbanes-Oxley Act of 2002 directs the Board to establish "ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports." Moreover, Section 103(b) of the Act directs the Board to establish rules on auditor independence "as may be necessary or appropriate in the public interest or for the protection of investors, to implement, or as authorized under, Title II of th[e] Act."

In early 2003, the Securities and Exchange Commission adopted new independence rules in order to implement Title II of the Act. Neither the Act nor the SEC's 2003 independence rules prohibit tax services, as long as the services were pre-approved by the company's audit committee and did not fall into one of the categories of expressly prohibited services.

Since the SEC issued its new rules, two types of tax services have raised serious questions from investors, auditors, regulators, and others relating to the ethics and independence of accounting firms that provide both auditing and tax services. First, the Internal Revenue Service and the Department of Justice have brought a number of cases against accounting firms in connection with those firms' marketing of tax shelter products and, specifically, those firms' alleged failures to register, or comply with list maintenance requirements relating to, their tax shelter products. In addition, in November 2003, the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs held hearings on tax shelters in which the

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subcommittee elicited testimony that described certain potentially abusive tax shelter products marketed through cold-call selling techniques by accounting firms and others. Second, audit firms have been criticized for providing tax services, including tax shelter products, to senior executives of public company audit clients. Some have questioned whether an auditor's provision of such services could lead to conflicts of interest.

Over the last year, the Board has evaluated whether an auditor's provision of tax services, or any class of tax services, to an audit client impairs the auditor's independence from that audit client, in fact or appearance. As part of this evaluation, the Board held a public roundtable discussion with individuals representing a variety of viewpoints, including investors, auditors, managers of public companies, governmental officials, and others. (A transcript of the roundtable is available on the Board's Web site.)

Proposed Ethics and Independence Rules

The proposed rules fall into three areas. First, the proposed rules would identify three circumstances in which the provision of tax services impairs an auditor's independence –

- Proposed Rule 3521 would treat registered public accounting firms as not independent of their audit clients if they enter into contingent fee arrangements with those clients.
- Proposed Rule 3522(a) and (b) would treat a registered public accounting firm as not independent from an audit client if the firm provides services related to planning or opining on the tax consequences of a transaction that is a listed or confidential transaction under Treasury regulations. In addition, proposed Rule 3522(c) includes a provision that would treat a registered public accounting firm as not independent if the firm provides services related to planning or opining on a transaction that is based on an aggressive interpretation of applicable tax laws and regulations.
- Proposed Rule 3523 would set a new requirement to treat a registered public accounting firm as not independent if the firm provided tax services to officers in a financial reporting oversight role of an audit client.

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Second, the proposed rules would further implement the Act's pre-approval requirement further by strengthening the auditor's responsibilities in connection with seeking audit committee pre-approval of tax services. Specifically, proposed Rule 3524 would require a registered public accounting firm that seeks such pre-approval to supply the audit committee with certain information, discuss with the audit committee the potential effects of the services on the firm's independence, and to document the substance of that discussion.

Third, the rules lay a foundation for the Board's independence rules. Specifically, proposed Rule 3502 would codify, in an ethics rule, the principle that persons associated with a registered public accounting firm should not cause the firm to violate relevant laws, rules, and professional standards due to an act or omission the person knew or should have known would contribute to such violation. Proposed Rule 3520 would include a general obligation requiring registered public accounting firms to be independent of their audit clients throughout the audit and professional engagement period.

Finally, the proposed rules also include several definitions that would be integral to the operation of the rules.

Other Tax Services

The release would also discuss other types of tax services that the Board's proposed rules would not prohibit, along with the Board's reasoning with respect to these services. These services include routine tax return preparation and tax compliance, general tax planning and advice, international assignment tax services, and employee personal tax services.

Public Comment

If the Board issues the proposed rules and release, it will seek comment on the proposed rules for a 60-day period. The Board will carefully consider all comments received. Following the close of the comment period, the Board will determine whether to adopt final rules. Any final rules will be submitted to the Securities and Exchange Commission for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission.

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The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.