



February 14, 2005

Ms. Bella Rivshin, Assistant Chief Auditor  
Mr. Greg Scates, Associate Chief Auditor  
Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, N.W.  
Washington, D.C. 20006

[comments@pcaobus.org](mailto:comments@pcaobus.org)

Re: Rulemaking Docket Matter No. 017

Dear Ms. Rivshin and Mr. Scates:

Thank you for allowing an opportunity to comment on the Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees. I am Tax Counsel with Taxware LP, a global provider of automated transaction tax software.<sup>1</sup>

Taxware provides integrated, Sarbanes-Oxley compliant, digital solutions for transaction tax calculation and return preparation in over 170 foreign and over 7,500 state and local tax jurisdictions in the U.S. Most of our clients are registered with the Securities and Exchange Commission and are audited by firms overseen by the Public Company Accounting Oversight Board.

Taxware supports the PCAOB's efforts to improve ethics and auditor independence in the area of non-audit tax services. However, with respect to Proposed Rule 3522 we believe that the rule, as currently drafted, is too narrowly drawn and unnecessarily establishes two standards for determining auditor independence in relation to "planning, or opining" on tax shelter transactions. It would be preferable to have a single, well-principled rule drafted along the lines of 3522 (c) followed by an expanded series of examples drafted along the lines of 3522 (a) and (b) that are culled from a reasonably wide variety of taxes and from an equally wide variety of tax jurisdictions.

#### INTRODUCTION

Abusive tax shelters are a global problem, one that is recognized across all tax jurisdictions, and across all tax-types.<sup>2</sup> Auditor independence and investor confidence in the

<sup>1</sup> An earlier article published on the topic of this letter has been attached. "Global Changes in Regulating Corporate Auditors: A Comparative Assessment," *Tax Notes International* (December 20, 2004) page 1029.

<sup>2</sup> See for example the establishment of the Joint International Tax Shelter Information Center (JITSIC) among the United States, United Kingdom, Australia, and Canada on April 23, 2004. "The participating countries bring to the task force different, specialized expertise in fighting tax avoidance. The United Kingdom's expertise lies in identifying and uncovering avoidance mechanisms, especially those concerning VAT, whereas the United States

financial statements they produce are impacted just as strongly when the auditor is promoting an abusive tax shelter in the US market<sup>3</sup> as it is when the auditor is promoting an abusive tax shelter in the UK market. US and UK revenue authorities are equally concerned, and have established similar regulations that require promoters and their clients to disclose to revenue authorities the use of similar, defined abusive tax shelters. However, Proposed Rule 3522 appears to operate with one standard for auditors that promote US shelters (subsections (a) and (b)), and a different standard for auditors that promote UK shelters (subsection (c)).

Additionally, there is no difference (measured in terms of auditor independence or investor confidence) whether the auditor is promoting an abusive value added tax (VAT) shelter, or an abusive income tax shelter to an audit client. As a result, in jurisdictions where the VAT is a major revenue source, like the UK and Australia, there are a parallel disclosure-based enforcement structures that target promoters of abusive VAT shelters and their clients. Nevertheless, Proposed Rule 3522 operates with one standard for US income tax shelters (subsections (a) and (b)), and a different standard for VAT shelters (subsection (c)).

The importance of these rules on auditor independence and the provision of non-audit tax services cannot be understated. They are keystone regulations. They cap a series of statutory and regulatory efforts by Congress and the SEC to move US security regulation closer to international norms. As currently drafted however, Proposed Rule 3522 fails to advance this effort toward an “objectives-oriented” standard. Proposed Rule 3522 appears to regress and revert to the kind of “rules-based” regulation that Congress encouraged the SEC to abandon in section 108(d) of the Sarbanes-Oxley Act.

#### PROPOSED RULE 3522

Proposed Rule 3522 provides:

“A registered public accounting firm is not independent of its audit client if the firm or any affiliate of the firm, during the audit and professional engagement period, provides any non-audit services to the audit client relating to planning, or opining on the tax treatment of, a transaction --”

The rule then identifies three categories of transactions: “(a) Listed Transactions ... (b) Confidential Transactions ... or (c) Aggressive Tax Positions ...” each of which are deemed to deny the auditor independence if the auditor or an affiliate provides non-audit planning or opinion services on them to the audit client.

Both “listed transaction” and “confidential transaction” are defined specifically and exclusively with reference to US Treasury Regulations, 26 C.F.R. § 1.6011-4(b)(2) and 26 C.F.R.

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specializes in corporate and income tax avoidance and offshore tax shelters. ... On May 3 U.K. tax authorities issued a statement that the work will target ‘the ways in which financial products and derivative arrangements are used in abusive tax schemes by corporations and individuals to reduce their tax liabilities,’ and will identify ‘promoters developing and marketing those products and arrangements.’” Bruce Zagaris, “International Tax Enforcement Continues to Increase,” *Tax Notes International* (August 25, 2004); 2004 WTD 165-13; Sirena J. Scales, “Multinational Task Force Created to Combat Abusive Tax Avoidance,” *Tax Notes International* (April 27, 2004); 2004 WTD 81-3.

<sup>3</sup> The PCAOB is urged by the US Senate Permanent Subcommittee on Investigations in its recently released investigation report, *The Role of Professional Firms in the US Tax Shelter Industry* (February 8, 2005) to “... strengthen and finalize proposed rules restricting certain accounting firms from providing aggressive tax services to their audit clients, charging companies a contingent fee for providing tax services, and using aggressive marketing efforts to promote generic tax products to potential clients.”

- (1) The premium fee test: If a promoter (or a connected person) would not be able to obtain a premium fee for the arrangement, then the arrangement would not be subject to disclosure. A premium fee is chargeable by virtue of any element of the arrangement from which an expected tax advantage arises and must be to a significant extent attributable to or contingent on the obtaining of the advantage.
- (2) The confidentiality test: A transaction is confidential if a promoter might reasonably be expected to want to keep the tax avoidance element confidential in the sense of wanting to keep the tax operation of the scheme hidden from competitors.
- (3) The off-market test: If a promoter (or a connected person) becomes a party to the financial product (typically where a banking institution becomes a party to a financial product), then this test seeks to determine if the terms of the financial product differ from what could have been obtained on the open market.<sup>6</sup>

The US tax shelter disclosure rules are set out very differently. The US identifies particular kinds of transactions that are deemed *per se* to constitute an abusive tax shelter subject to disclosure requirements. These are “bright line” tests. *Notice 2004-67*<sup>7</sup> is the most recent update of the slate of “listed transactions” under sections 6011 and 6111. *Notice 2004-67* restates the transactions listed in prior *Notice 2003-76*<sup>8</sup> and adds transactions identified in subsequent guidance.

*Notice 2004-67* identifies 30 discrete transactions-types, each of which is deemed *per se* to be an abusive tax shelter:

- Some items reference IRS litigation, like: “(3) Transactions substantially similar to those at issue in *ASA Investering Partnership v. Commissioner*, 20F.3d 505 (D.C. Cir. 2000) and *ACM Partnership v. Commissioner*, 157 F.3d 231 (2d Cir. 1998) (transactions involving contingent installment sales of securities by partnerships in order to accelerate and allocate income to a tax-indifferent partner, such as a tax-exempt entity or foreign person, and to allocate later losses to another partner (identified as “listed transactions” on February 28, 2000).”
- Others items reference *IRS Regulations*, like: “(6) *Section 1.7701(l)-3 of the Income Tax Regulations* (transactions involving fast-pay arrangements as defined in section 1.7701(l)-3(b) (identified as “listed transactions” on February 28, 2000).”
- Still other items reference *IRS Revenue Rulings*, like: “(7) *Rev. Rul. 2000-12. 2000-1 C.B. 744* (certain transactions involving the acquisition of two debt instruments the values of which are expected to change significantly at about the same time in opposite directions (identified as “listed transactions” on February 28, 2000).”

It is certainly possible, given these divergent definitional schemes, that the US and UK will not reach the same result, on occasion, as to whether or not a particular transaction constitutes an abusive tax shelter. For example, based on just the materials above, two scenarios can be hypothesized where this would happen:

- (A) Financial transactions that escape the UK net can be caught by the US rules. A transaction that violates *Rev. Rul. 2000-12* under the US rules could be common enough to fail the UK’s confidentiality test.

<sup>6</sup> *Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2004* (SI 2004/1863).

<sup>7</sup> *Notice 2004-67*; 2004-41 IRB 1, release date September 24, 2004.

<sup>8</sup> *Notice 2003-76*, 2003 IRB 1181.

- (B) UK tax rules might identify a transaction that would violate the “spirit” of what the US deems to be a tax shelter. However, because the IRS “lists” abusive tax shelter transaction retrospectively, the particular fact pattern is at the time “un-listed.” It has either not been the subject of litigation, or it has not been previously identified in “other IRS guidance.”<sup>9</sup>

Differences like this are to be expected. Although both countries have income taxes, “local laws” differ. However, the constant in both systems is with the impact that these “local laws” have on investor confidence. This is where the concern of the PCAOB lies. When an auditor promotes an abusive tax shelter (as that concept is locally defined and understood) to audit clients, the impact on independence and investor-confidence is the same. Differences in technical definitions of what constitutes an abusive tax shelter are irrelevant to this inquiry. These are promotional activities that need to be prohibited.

*Abusive tax shelters in a Value Added Tax context.* The US is one of the few countries, and the only major economy in the world, that has not implemented a national level VAT. In many countries more revenue is generated through VAT than income tax. As a result, abusive VAT shelters are a concern as much, if not more often in some jurisdictions as are abusive income tax shelters.

Thus, when the UK adopted disclosure rules for abusive income tax shelters, rules requiring the disclosure of abusive VAT shelters were simultaneously adopted. Similar rules can be found in Australia.<sup>10</sup> Unlike the UK rules, the Australian VAT shelter rules do not have monetary penalties for non-disclosure. The Australian approach is to match vigorous enforcement with heightening professional standards. The Australian rules do require disclosure by the auditor, unlike the UK rules that compel the corporation to disclose VAT shelters.<sup>11</sup>

Thus, Proposed Rule 3522 should incorporate specific reference to abuse tax shelter regulations in foreign jurisdictions, and in taxes other than the income tax in a manner similar to that way that US Treasury regulations are referenced in sections (a) and (b) of the current Proposed Rule.<sup>12</sup>

## A KEYSTONE RULE

<sup>9</sup> This fact pattern has been recognized by the PCAOB as a potential problem. At page 29 of PCAOB Release No. 2004-015 the Board observes: “Although the proposed rule does not address situations in which a transaction planned, or opined on, by the auditor becomes listed after it is executed, the Board seeks comments on whether the rule should address the possible impairment of an auditor’s independence in such situations.” The reason that this fact pattern is perceived as a problem is attributable to the structural design of the rule. Proposed Rule 3522 (a), as currently positioned, functions like a bright line test. While it is possible to respond to this concern by stating that Proposed Rule 3522 (c) functions as a general rule capturing transactions that fall outside the scope of Proposed Rule 3522 (a), it is unlikely that such an interpretation will survive the heat of a contested independence inquiry. The clear tendency will be to read this as a bright line, unless the substance of this rule is reconstituted as an example, one of many examples, of independence violations under these rules. Such a structure would place the independence burden where it truly belongs, on the professional judgment of the auditor, and not on the blind reliance on bright-line tests.

<sup>10</sup> For the Australian rules see: <http://www.ato.gov.au/atp/>

<sup>11</sup> See *The Value Added Tax (Disclosure of Avoidance Schemes) Regulation 2004* (SI 2004/1929). Available at: <http://www.legislation.hmso.gov.uk/si/si2004/20041929.htm>

<sup>12</sup> It is not just foreign jurisdictions that have rules on abusive tax shelters. Consideration should be given in an example format for the inclusion of specific references to state legislation when disclosure-based tax shelter rules are adopted. See for example: CAL. REV. and TAX CODE § 18628.

§ 1.6011-4(b)(3). An “aggressive tax position” however, is defined more generally and as a result becomes a second standard, one that encompasses by default promotions of all non-income-tax-based abusive tax shelters, as well as all abusive tax shelters under foreign tax systems that do not violate the cited US Treasury regulations. Under this second standard a tax position that is “initially recommended by the registered public accountant” but which has “tax avoidance” as a “significant purpose” is deemed to compromise auditor independence, *but only if* the tax treatment is “more likely than not” to be allowable under “applicable tax laws.”

These are very different rules. The rules under Proposed Rule 3522 (a) “Listed Transactions,” and 3522 (b) “Confidential Transactions” are classic bright line tests, whereas the rule under Proposed Rule 3522 (c) “Aggressive Tax Positions,” is a measured, sliding-scale rule that requires professional judgments about both the “significant purpose” of the non-audit tax services, and whether the “tax position” is “more likely than not” to be allowable under “local law.”

#### SUGGESTED REDESIGN OF PROPOSED RULE 3522

Proposed Rule 3522 should be redrafted. The design should elevate section 3522 (c) to a dominant position, and relegate 3522 (a) and 3522 (b) to a lesser status where they function as two among many examples of the kinds of “tax positions” that the PCAOB would deem to clearly violate of the intent of the standard.

At this point the PCAOB should add several more examples, drawn from the abusive income tax and VAT shelter rules of foreign jurisdictions. These additions would underscore that what constitutes an abusive tax shelter (the promotion of which by the auditor to clients would compromise independence damage investor confidence) may vary by tax jurisdiction and tax-type.

#### OTHER ABUSIVE TAX SHELTER REGULATIONS

In the U.K. abusive tax shelter disclosure rules came into force on August 1, 2004. There are two sets of rules, one issued under the income tax by the Inland Revenue Service,<sup>4</sup> and another issued under the VAT by H.M. Customs and Excise.<sup>5</sup> Both sets of regulations require disclosure to the government of defined tax shelter activities. However, under income tax rules both the promoter and the taxpayer are required to make disclosures, whereas under VAT rules only the taxpayer has disclosure obligations.

*Comparison of tax shelter transactions subject to disclosure under US and UK income tax rules.* Although the overall design of the US and UK tax shelter disclosure rules are similar (promoters under both systems are subject to penalties for failure to disclose) there are important differences in details. The most significant of these concern the definition of the kinds of tax schemes that are subject to disclosure. The essential UK-US difference is somewhat akin to the difference between fishing with a net or fishing with a series of lines and baited hooks. The UK approach sweeps broadly, but allows certain transactions to escape through holes in the net, where the US approach is one that pursue discrete, narrowly defined transactions that have been identified by the IRS as abusive in prior litigation or rulings.

Thus, for example, the UK tax shelter rules apply broadly to all arrangements involving financial products, except those that fail any of the following three tests or “filters:”

<sup>4</sup> Regulations 2004 No. 1863; 1864; 1865; 2429; 2613. Available at: <http://www.inlandrevenue.gov.uk/aiu/index.htm>

<sup>5</sup> Notice 700/8, “Disclosure of VAT Avoidance Schemes.” Available at: <http://www.hmce.gov.uk>

The importance of these rules cannot be understated. These rules represent much more than a set of rules about ethics, independence, and the provision of non-audit tax services. They are, in fact, the final and keystone pieces in a coordinated effort of the US Congress, and the Securities and Exchange Commission to move US security regulation closer to international norms.

The SEC's *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System*<sup>13</sup> was critical of prevailing rulemaking, and urged the adoption of an "objectives-oriented" standard whenever possible.

The SEC criticized a "principles-only" approach to standards, an approach favored by the EU. Principles-only standards were not reliably operational. The SEC observed that under a "... principles-only approach auditors are required to exercise significant judgment in applying overly-broad standards to more specific transactions and events..."<sup>14</sup> However, the SEC was also critical of the US preference for "... rules-based standards [because they] can provide a roadmap to avoidance of the accounting objectives inherent in the standards. Internal inconsistencies, exceptions and bright-line tests reward those willing to engineer their way around the intent of the standards."<sup>15</sup>

The SEC envisioned a new methodology, one that it called an "objectives-oriented" approach to rule-making. This standard has five distinct elements:

- (1) It is based on a consistently applied conceptual framework.
- (2) It clearly states the accounting objective.
- (3) It provides sufficient detail and structure so that the standard can be operationalized and applied on a consistent basis.
- (4) It minimizes exceptions from the standard.
- (5) It avoids the use of percentage ("bright-line") tests that allow financial engineers to achieve technical compliance with the standard while evading its intent.<sup>16</sup>

What makes the PCAOB's proposed rules on ethics, independence, and tax services so important is that they constitute the third, and last to be adopted, of the five elements in the design of an objectives-oriented standard on non-audit tax services and auditor independence.

The production of comprehensive, objectives-oriented standards cannot be the work of the PCAOB alone. It is a cooperative effort, involving the US Congress, the SEC and the PCAOB. Nothing could make the dynamics of this cooperation clearer than to observe the development of rules in this area of auditor independence. Elements (4) and (5) have been contributed by the US Congress in the Sarbanes-Oxley Act. Elements (1) and (2) have been set in place through SEC regulation. Element (3) is the last piece. Congress expressly provided that the PCAOB was to draft the rules for this last section.<sup>17</sup>

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<sup>13</sup> Available at: <http://www.sec.gov/news/studies/principlesbasedstand.htm>

<sup>14</sup> SEC, *Study Pursuant to Section 108(d)*, at 6.

<sup>15</sup> SEC, *Study Pursuant to Section 108(d)*, at 6.

<sup>16</sup> SEC, *Study Pursuant to Section 108(d)*, at 4-5.

<sup>17</sup> Congress determined that the PCAOB would draft these rules in section 201(a)(9) of the Sarbanes-Oxley Act of 2002 (P.L. 107-204, 116 Stat. 274.101).

*US Congress:* The fourth element of an “objectives-oriented” standard is that exceptions must be minimized. The fifth is that bright-line tests must be avoided. The Sarbanes-Oxley Act contributed directly to meeting both of these requirements through the modification of the Levitt regulations. The Sarbanes-Oxley Act eliminated twenty-five distinct exceptions, percentage limitations and bright line tests in the area of auditor independence. Each of these provisions had allowed financial engineers to achieve technical compliance with the standard while evading its intent.

*SEC Regulation:* The first element of an “objectives-oriented” standard is that rules should be based on a consistently applied conceptual framework. The second is that rules should clearly state the regulatory objective. The SEC applies a consistent conceptual framework to all non-audit services. SEC regulation makes it clear that a three-part structure is applied to determine the appropriateness of any non-audit service. Non-audit services are either (a) allowed and approved by the audit committee; or (b) allowable but not approved by the audit committee; or they are (c) prohibited because they violate one or more of the governing principles.<sup>18</sup> The audit committee discriminates between audit services in category (a) and (b) by weighing efficiency and investor protection considerations.<sup>19</sup>

The SEC also makes it clear that the same basic objectives are applicable to all non-audit services. These “simple principles” of auditor independence are discussed in the final regulations: ... the principles of independence with respect to services provided by auditors are largely predicated on three basic principles, violations of which would impair the auditor's independence:

- (1) an auditor cannot function in the role of management,
- (2) an auditor cannot audit his or her own work, and
- (3) an auditor cannot serve in an advocacy role for his or her own client.<sup>20</sup>

Although presented here as three, rather than four, principles<sup>21</sup> the SEC expressly references the “basic principles” of auditor independence placed by the Levitt reforms in the *Preliminary Note* to Rule 2-01 of Regulation S-X, 17 CFR 210.2-01.

In the context of cooperative global cooperation in security regulation, both the Congressional elimination of exceptions and bright line tests, as well as the SEC’s emphasis on basic principles and a consistently applied framework have had wide international resonance. Even though there are “framework” differences over the role of the audit committee, the recognition of commonly accepted basic principles unrestricted by exceptions, limitations and

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<sup>18</sup> Wardell, Thomas, *International Accounting Standards in the Wake of Enron: The Current State of Play under the Sarbanes-Oxley Act of 2002*, 28 North Carolina Journal of International Law and Commercial Regulation, 935 (Summer, 2003); *The Good the Bad and Their Corporate Code of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior*, 116 Harvard Law Review, 2123 (May, 2003).

<sup>19</sup> Durst, Michael C. & Thomas H. Gibson. “Audit” vs. Non-Audit” *Tax Services under Sarbanes-Oxley*. The Tax Executive (November-December, 2003) 474-477.

<sup>20</sup> SEC, *Final Rule. Strengthening the Commission's Requirements Regarding Auditor Independence*, effective May 6, 2003; [www.sec.gov/rules/final/33-8183.htm](http://www.sec.gov/rules/final/33-8183.htm). See also: PCAOB, *Briefing Paper: Auditor Independence Roundtable*, (July 14, 2004) at 4. See: [http://www.pcaobus/documents/standards/Briefing\\_Paper%20-%20Independence\\_Roundtable.pdf](http://www.pcaobus/documents/standards/Briefing_Paper%20-%20Independence_Roundtable.pdf)

<sup>21</sup> There seems to be some ambiguity with respect to whether there are three or four principles. In its *Briefing Paper: Auditor Independence and Tax Services Roundtable*, the PCAOB specifically recites, without comment, the “four overarching principles that inform the Commission’s application of the general standard of independence,” and in the next paragraph recites the shorter list of “three basic principles.” (pages 4-5).

bright line tests has been welcomed.<sup>22</sup> It is time for the PCAOB to play its part, and it needs to be consistent with the prior efforts of the Congress and the SEC.

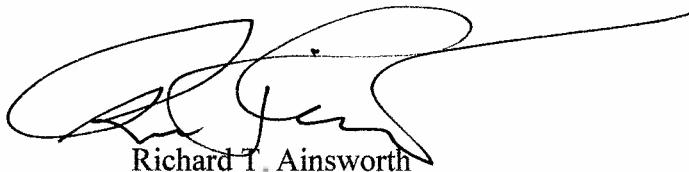
### CONCLUSION

Thus, the PCAOB stands at a critical design juncture with respect to these Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees. To complete the design an “objectives-oriented” standard the PCAOB needs to draft rules that “... provide sufficient detail and structure that the standard can be operationalized and applied on a consistent basis...” without retreating into a “... rules-based ... roadmap ... [of] inconsistencies, exceptions and bright-line tests [that] reward those willing to engineer their way around the intent of the standards.”<sup>23</sup>

This is a difficult undertaking. However the way forward seems reasonably clear. Proposed Rule 3522 (c) needs to be elevated into the status of a general rule. Proposed Rule 3522 (c) places heavy emphasis on the exercise of good professional judgment. However, left by itself, such a rule would fall victim to the SEC criticism of “principles-only” standard-setting.

Therefore Proposed Rule 3522 (c) needs to be coupled with specific examples drawn widely from tax jurisdictions, and tax-types around the world. In particular the PCAOB needs to seek out those rules that adopt auditor and company disclosure requirements when combating tax shelter activities. Rules that are similar to those in the U.S. Treasury regulations at 26 C.F.R. § 1.6011-4(b)(2) and 26 C.F.R. § 1.6011-4(b)(3), or U.K. *Notice 700/8*, “Disclosure of VAT Avoidance Schemes;” or U.K. *Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2004* (SI 2004/1863) should be preferred. In this manner the PCAOB will provide auditors with sufficient detail and structure so that the independence standard can be operationalized and applied on a consistent, global, and diversified tax-type basis.

Sincerely,

A handwritten signature in black ink, appearing to read 'Richard T. Ainsworth', with a long horizontal flourish extending to the right.

Richard T. Ainsworth

<sup>22</sup> For example the EU formulation can be found in the *Consultative Paper on Statutory Auditor's Independence in the EU: A Set of Fundamental Principles*, (December 15, 2000) at 3(1) and (2). Available at: [http://europa.eu.int/comm/internal\\_market/en/company/audit/news/independence\\_en.pdf](http://europa.eu.int/comm/internal_market/en/company/audit/news/independence_en.pdf); the UK framework was introduced in 1997, and was placed into conformance with the EU framework in June 2002, Institute of Chartered Accountants in England and Wales, *Guide to Professional Ethics: Introduction and Fundamental Principles, Statement 1.200 Revised*, (2002); the Australian reforms are found in the Corporations Act at sections 324CE(7) and 324CF(7). *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004*, No. 103, 2004. At: <http://scaleplus.law.gov.au/html/comact/browse/TOCN.htm>.

<sup>23</sup> SEC, *Study Pursuant to Section 108(d)*, at 6.



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# **Global Changes in Regulating Corporate Auditors: A Comparative Assessment**

**by Richard T. Ainsworth**

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# Global Changes in Regulating Corporate Auditors: A Comparative Assessment

by Richard T. Ainsworth

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**A**uditor independence was a global concern of financial regulators in the 1990s. Some observers saw this in a positive light, as a natural development. Adjusting auditor independence rules was a manifestation of global convergence in corporate governance structures.<sup>1</sup> New rules, especially rules leaning toward a harmonized system, were welcome.

There was a more sobering view. This view held that global regulators were less concerned with convergence than they were with a sense of impending disaster. Things had gone too far. Significant, maybe even radical, change was needed. The independence of corporate auditors had eroded; trust had been fundamentally compromised in the quest for audit firm profits. Corrective measures were needed immediately to avert widespread financial collapse.

The new century brought startling events: the collapse of HIH (March 2001)<sup>2</sup> and One.Tel (July 2001)<sup>3</sup>

<sup>1</sup>Considerable academic discussion has focused on the global convergence of corporate governance practices. See, e.g., L.A. Bebchuck and M.J. Rowe, "A Theory of Path Dependence in Corporate Ownership and Governance," (1999) 52 *Stan. L. Rev.* 127; A.N. Licht, "The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems," (2001) 26 *Del. J. of Corp. L.* 147; L.E. Ribstein, "Politics, Adaptation and Change," (2001) 8 *Aust. Jnl. of Corp. L.* 246; and R. Romano, "A Cautionary Note on Drawing Lessons from Comparative Corporate Law," (1993) 102 *Yale L. J.* 2021. Some have seen that convergence "coinciding with the civil/common law divide" (Paul von Nessen, "Corporate Governance in Australia: Converging with International Norms," (2003) 15 *Aust. Jnl. of Corp. L.* 1, 47, n. 73, citing further to P.G. Maloney, "The Common Law and Economic Growth: Hayek Might Be Right," (2001) 30 *J. Leg. Stud.* 503). That "divide" is not apparent in the response of the Japanese government to the auditor independence issue considered in this paper.

<sup>2</sup>HIH was the largest general insurance company in Australia. Accounting entries hid claims that exceeded accounting reserves, forcing the company's liquidation. See HIH Royal Commission (Justice Neville Owen), *Report of the HIH Royal Commission*, 2003 at <http://www.hihroyalcom.gov.au/finalreport/> and M. De Martinis, "Do directors, regulators, and auditors speak, hear and see no evil? Evidence from the Enron, HIH and One.Tel collapses," (2003) 15 *Aust. Jnl. of Corp. L.* 66.

in Australia; and the bankruptcy of Enron (October 2001)<sup>4</sup> and WorldCom (June 2002)<sup>5</sup> in the United States. Similar scandals broke in the European Union. There was Vivendi (July 2002) in France, Ahold (February 2003)<sup>6</sup> in the Netherlands, and Parmalat (February 2003)<sup>7</sup> in Italy. Were the early years of this century a time of global convergence or a time of financial collapse attributable to widespread accounting failure?

This paper considers global changes in the regulation of the statutory corporate auditor. It focuses on nonaudit tax services as an instance when real movement toward convergence of corporate governance can be seen.

## I. Improving Auditor Independence Regulation

### A. European Union

*Auditor independence rules in the European Union.* During the 1990s the convergence of accounting regulation was a major concern in the European Union. The lack of a harmonized position on the role, position, and liability of the statutory auditor was seen as a barrier to the development of the single market. Not only was the quality of European audits affected, but the

<sup>3</sup>One.Tel was one of Australia's largest telecommunications companies. One.Tel paid lucrative performance bonuses to the directors when the company was on the verge of collapsing. That internal incentives could have rewarded directors of a failing company outraged Australians and accelerated reform efforts there.

<sup>4</sup>Enron was the seventh largest company in the United States. Sham transactions involving Cayman Islands entities improperly inflated asset values. See Peter Behr and April Witt, "Visionary's Dream Led to Risky Business: Opaque Deals, Accounting Sleight of Hand Built an Energy Giant and Ensured Its Demise," *The Washington Post*, July 28, 2002, at A-1.

<sup>5</sup>WorldCom was the second-largest long-distance carrier in the United States. Expenses for client development were booked as assets. See Carrie Johnson and Ben White, "WorldCom Arrests Made: Two Former Executives Charged With Hiding Expenses," *The Washington Post*, Aug. 2, 2002, at A-1.

<sup>6</sup>In Ahold, earnings were overstated because of improper booking of supplier discounts.

<sup>7</sup>In Parmalat, US \$3.5 billion in false assets were recorded in Cayman Islands subsidiaries.

European Union also felt handicapped when it tried to influence international accounting standards. That convergence theme was advanced in a green paper (1996)<sup>8</sup> and was soon followed by a communication from the commission (1998),<sup>9</sup> a consultative paper (2000),<sup>10</sup> a commission recommendation (2000),<sup>11</sup> and, finally, a comprehensive study of auditor liability (2001).<sup>12</sup>

### **Corrective measures were needed immediately to avert widespread financial collapse.**

When the accounting problems at Enron became public in October 2001, Europeans characterized the scandal as primarily a U.S. problem, one that “brought to light a number of significant international policy issues.” In simple terms, the problem was the U.S. preference for a “rules based approach to financial reporting.” The European Union, in contrast, “strongly promoted a strategy based on a principles-based approach to financial reporting, [one that was] designed to reflect economic reality and give[s] a true and fair view of the financial position and performance of a company. . . . [T]he heart of the [European] Union’s strategy [was] the application, from 2005, of International Accounting Standards (IAS) as the reporting framework for all listed EU countries.”<sup>13</sup>

In May 2003 the European Commission recommended changes in the 8th company law directive (84/

253/EEC) reflecting that position.<sup>14</sup> Auditor independence rules were part of that initiative.

According to the commission, what Europe needed was a set of harmonized, principles-based financial reporting and auditor independence rules that were based on five generalized “threats” to independence (self-interest, self-review, advocacy, familiarity or trust, and intimidation) and their associated “safeguards” (prohibitions, restrictions, policies and procedures, and disclosures within the audit firm, the audit client, and governance bodies).<sup>15</sup> The EU method relies heavily on documentation; it requires the auditor to demonstrate and document the exercise of good professional judgment. Threats need to be identified and safeguards applied whenever the situation demands.

*Nonaudit tax services and auditor independence in the European Union.* Nonaudit tax services were not a highlight of the reform. The European Union did not consider the provision of nonaudit tax services by the statutory auditor to be a separate and distinct threat to auditor independence. Therefore, general principles are applied. An auditor who provides nonaudit tax advice to a client is required to be alert to the possibility of a threat to independence. The auditor is instructed to document both that awareness and the safeguards that are considered and used to minimize or eliminate the threat. A tax-related activity that poses a threat that cannot be adequately minimized is prohibited.

The May 16, 2002, commission recommendation does not isolate tax services as a threat to independence. Tax services are not itemized in article 7, “Nonaudit services.” They are not specifically considered in the “General” rules at 7.1, nor are they used in the “Examples — analysis of specific situations” at 7.2. Only annex 1 mentions nonaudit tax services. There they are used as an example of an approved activity, one that poses no threat to independence.

[Routine valuation services involve situations] . . . where the underlying assumptions are determined by law (e.g., tax rates, depreciation rates for tax purposes), other regula-

<sup>8</sup>European Commission, *The Role, the Position and the Liability of the Statutory Auditor within the European Union*. 1996 Green Paper. O.J. No. C321,28.10.1996. At: [http://europa.eu.int/comm/internal\\_market/en/company/audit/news/staten.pdf](http://europa.eu.int/comm/internal_market/en/company/audit/news/staten.pdf).

<sup>9</sup>Communication from the European Commission, *The Statutory Audit in the European Union: The Way Forward*. May 7, 1998. O.J. No. C143, 8.5.1998. At: [http://europa.eu.int/comm/internal\\_market/en/company/audit/news/auditen.pdf](http://europa.eu.int/comm/internal_market/en/company/audit/news/auditen.pdf).

<sup>10</sup>European Commission, *Consultative Paper on: Statutory Auditors’ Independence in the EU*. Dec. 15, 2000. At: [http://europa.eu.int/comm/internal\\_market/en/company/audit/news/independence\\_en.pdf](http://europa.eu.int/comm/internal_market/en/company/audit/news/independence_en.pdf).

<sup>11</sup>European Commission Recommendation, *Quality Assurance for the Statutory Audit in the European Union: Minimum Requirements*. Nov. 15, 2000. At: <http://europa.eu.int/comm/eurostat/research/index.htm?http://europa.eu.int/en/comm/eurostat/research/viros/search3.htm&1>.

<sup>12</sup>European Commission, *A Study on Systems of Civil Liability of Statutory Auditors in the Context of a Single Market for Auditing Services in the European Union*. Jan. 15, 2001. At: [http://europa.eu.int/comm/internal\\_market/en/company/audit/docs/auditliability.pdf](http://europa.eu.int/comm/internal_market/en/company/audit/docs/auditliability.pdf).

<sup>13</sup>European Commission, *A First EU Response to Enron Related Policy Issues* (April 12 and 13, 2002). At: [http://europa.eu.int/comm/internal\\_market/company/docs/enron/ecofin\\_2004\\_04\\_enron\\_en.pdf](http://europa.eu.int/comm/internal_market/company/docs/enron/ecofin_2004_04_enron_en.pdf).

<sup>14</sup>See Commission of the European Community, *Communication from the Commission to the Council and the European Parliament: Modernising Company Law and Enhancing Corporate Governance in the European Union — A Plan to Move Forward*, COM (2003) 284 final. At: [http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003\\_0284en01.pdf](http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0284en01.pdf).

<sup>15</sup>See Commission of the European Union, *Commission Recommendation: Statutory Auditors’ Independence in the EU: A Set of Fundamental Principles*, at A(3)-(4). At: [http://europa.eu.int/eur-lex/pri/en/oj/dat/202/1\\_191/19120020719en00220057.pdf](http://europa.eu.int/eur-lex/pri/en/oj/dat/202/1_191/19120020719en00220057.pdf). See also Commission of the European Union, *Proposal for a Directive of the European Parliament and of the Council on Statutory Audit of Annual Accounts and Consolidated Accounts and Amending Council Directives 78/660/EEC and 83/349/EEC*.

tions (e.g., the provision to use certain interest rates), or are widely accepted within the Audit Client's business sector, and when the techniques and methodologies to be used are based on generally accepted standards, or even prescribed by laws and regulations. In such circumstances, the result of a valuation performed by an informed third party, even if not identical, is unlikely to be materially different. The provision of such valuation services might therefore not compromise a statutory auditor's independence, even if the valuation itself could be regarded as material to the financial statements, provided that the Audit Client or its management has at least approved all significant matters of judgment.<sup>16</sup>

In the 2004 commission proposal for the EU directive, nonaudit tax services remain unspecified.<sup>17</sup> The underlying assumption seems to be that threats to auditor independence from the provision of tax services are minimal, because the tax authorities regularly audit and assure compliance.

The recommendations of the commission are not binding EU legislation. The commission expects to review the country-by-country response to its recommendation in about three years. Binding legislation could follow if the commission is not satisfied with the laws enacted by the member states.

The European Union is clearly trying to achieve a European convergence in corporate governance. In terms of tax service the proposed directive is designed to accommodate very different views, like those of the United Kingdom and France. Those views will be considered in detail in the next sections. Where the United Kingdom seeks more specific guidance on tax services, the French simply prohibit all tax services without any guidance at all. The hope in the EU is that a way can be found to craft a harmonized set of rules for the union during the three-year experimental period.

## B. The United Kingdom

*Auditor independence rules in the United Kingdom.* The United Kingdom takes the provision of nonaudit tax services by the statutory auditor more seriously

than the commission. The secretary of state for trade and industry and the chancellor of the exchequer established the Coordinating Group for Audit and Accounting Issues to examine U.K. auditor independence rules and make recommendations for regulatory change. The final report was issued on January 29, 2003. Although generally adopting the EU principles-based method, the report goes further than the European Union on tax services. A "strong case" is made for more "specific guidance" in the area of tax services. It states:

*Taxation Services.* There are no specific requirements or guidance in existing U.K. Standards, though of course threats to independence have to be considered against the principles of auditor independence referred to at para 1.35 above. The amount of taxation services supplied by the auditor to the company can be considerable. However, the considerations to be taken into account in deciding whether or not to supply them are no different in principle from those that apply to other nonaudit services. In essence, when the taxation service involves the application of well tried and tested tax law, no difficulties arise. And in any event the tax authorities review the work and generally welcome the close involvement of the auditors. In the circumstances when a particular piece of advice or position taken is material to the financial statements, and when the outcome is subjective or otherwise significantly uncertain, this should be disclosed to the audit committee and careful consideration should be given to the safeguards that must be put in place, including perhaps the need for the company to obtain an independent second opinion. We think therefore that there is a strong case for further consideration by the standard setting body, with a view in particular to the need for specific guidance.<sup>18</sup>

In October 2004 the U.K. Auditing Practices Board (part of the Financial Reporting Council, the new U.K. accounting regulator) completed a revision of ethical standards. For the first time, "specific requirements" on the provision of nonaudit tax services were provided. The standards are effective for audits of financial statements beginning after December 15, 2004. Two nonaudit tax services are prohibited: the promotion of "tax structures or products . . . where the audit partner has, or ought to have, reasonable doubt

<sup>16</sup>Commission Recommendation of May 16, 2002, *Statutory Auditors' Independence in the EU: A Set of Fundamental Principles* (2002/590/EC). OJ L 191/22, 19.7.2002. That same approach to nonaudit tax services was taken in the related *Consultative Paper on Statutory Auditors' Independence in the EU: A Set of Fundamental Principles*, *supra* note 10.

<sup>17</sup>Commission of the European Union, *Proposal for a Directive of the European Parliament and of the Council on Statutory Audit of Annual Accounts and Consolidated Accounts and Amending Council Directives 78/660/EEC and 83/349/EEC*, *supra* note 15.

<sup>18</sup>Coordinating Group for Audit and Accounting Issues, *Final Report*, Jan. 29, 2003, p. 32. At: <http://www.dti.gov.uk/cld/cgaai-final.pdf>.

as to the appropriateness of the related accounting treatment involved" and the provision of "tax services to an audit client wholly or partly on a contingent fee basis."<sup>19</sup>

Despite the movement toward stricter standards, the U.K.'s general approach, like that of the European Union, is to rely heavily on the oversight function of tax authorities. Most tax services are permissible under both approaches. Differences are more than a matter of perspective. Although EU standards seem to nod affirmatively in favor of tax services, the new U.K. rules take a more skeptical stance. The United Kingdom provides some guidance on how to analyze the threats to auditor independence that arise from tax services and sets forth certain tax services for which no safeguard is sufficient protection for investors.

### C. France

*Auditor independence rules in France.* Auditor independence reforms became law in France while work on the 8th company directive in the European Union progressed. French law had long employed a principles-based approach to auditor regulation. The *Companie nationale des commissaires aux comptes* (CNCC) and the *Commission des opérations de bourse* (COB) presented a report in 1997 that supported a principles-based approach and rejected a U.S.-styled rules-based system.<sup>20</sup> A post-Enron study by AFEP-AGREF (*Association Française des Entreprises Privées et Association des Grandes Entreprises Françaises*) supported changes in French law, but not its regulatory method. It indicated that "French companies find themselves in a very different situation from that of their US counterparts. In many respects, French companies are better protected against the risk of excessive or misguided practices."<sup>21</sup>

The French response was the *Loi de Sécurité Financière*. The law modified the content, but not the underlying theory of French auditor independence rules. It was approved July 17, 2003, and published August 2, 2003.<sup>22</sup>

<sup>19</sup>Auditing Practices Board, "APB Ethical Standard 5 — Non-audit Services Provided to Audit Clients," paragraphs 66 and 68. Available at: <http://www.frc.org.uk/apb/publications/ethical.cfm>.

<sup>20</sup>CNCC/COB Working Group on Independence and Objectivity of the Statutory Auditors of Public Companies, *Summary of the December 1997 Report* (April 3, 1998) [in English] at: [http://www.amf-france.org/styles/default/documents/general/4151\\_1.pdf#xml=http://www.amf-france.org:80/snqhilight/xml104](http://www.amf-france.org/styles/default/documents/general/4151_1.pdf#xml=http://www.amf-france.org:80/snqhilight/xml104).

<sup>21</sup>AFEP-AGREF, *Promoting Better Corporate Governance in Listed Companies*, Sept. 23, 2002. At: [http://www.medef.fr/staging/medias/upload/367\\_FICHER.pdf](http://www.medef.fr/staging/medias/upload/367_FICHER.pdf).

<sup>22</sup>The *Loi de Sécurité Financière* is published in the Official French Journal, Aug. 2, 2003. In French at: <http://www.legifrance.gouv.fr/Waspad/UnTexteDeJorf?numjo=ECOX0200186L>.

*Nonaudit tax services and auditor independence in France.* The *Loi de Sécurité Financière* prohibits the auditor from performing any nonaudit services. No distinction is drawn among types of nonaudit tax services. Thus, the French view, like that of the United Kingdom, is fully compatible with the EU position on auditor independence; principles, not rules, should determine the permissible scope of nonaudit tax services. However, France has staked out an extreme position. Under French law, performing nonaudit tax services poses such a "threat" to auditor independence that there is no acceptable "safeguard."<sup>23</sup>

### D. United States

*Auditor independence rules in the United States (pre-Sarbanes-Oxley).* On June 30, 2000, the U.S. Securities and Exchange Commission under Chairman Arthur Levitt proposed revisions to the SEC's auditor independence rules.<sup>24</sup> Those amendments were adopted on November 21, 2000. They were fashioned through compromise, blending what the SEC proposed with what the accounting profession would accept. They are classic examples of rules-based regulation. Nine types of nonaudit services were deemed to be inconsistent with auditor independence. Most of the prohibitions were severely limited. All but three (management, broker-dealer, and legal services) were riddled with exceptions.

## Eliminating exceptions was more than a reaction to Enron: It constituted a change in regulatory theory.

*Nonaudit tax services and auditor independence in the United States (pre-Sarbanes-Oxley).* The Levitt reforms, like the EU proposals and the older U.K. standards, treat tax services as a special category of nonaudit services. In all three systems, they are generally deemed to be immune from auditor independence problems because of Treasury/Inland Revenue/IRS oversight. According to the SEC/Levitt reforms, "An accountant's independence should not be deemed impaired when the accountant performs

<sup>23</sup>This opinion is not limited to the French government. The respected opinion is that the United States would agree with a very restricted role for the statutory auditor. See, e.g., Harvard Law School Professor Bernard Wolfman's letter to the SEC when the SEC was drafting the Sarbanes-Oxley rules on auditor independence. "To assure auditor independence the Commission must require that auditors of public companies stick to auditing, leaving consulting (including all tax services other than return preparation and compliance work) to others." At: <http://www.sec.gov/rules/proposed/s74902/bwolfman1.txt>.

<sup>24</sup>SEC, *Final Rule: Revision of the Commission's Auditor Independence Requirements*, RIN 3235-AH91 (Oct. 12, 2001). At: <http://www.sec.gov/rules/final/33-7919.htm>.

appraisal or valuation services as a necessary part of permitted tax services. As the rule text and this Release make clear, accountants will continue to be able to provide tax services to audit clients . . . [and even with respect to contingency fee arrangements] tax services generally do not create the same independence risks as other non-audit services.”<sup>25</sup>

This is not to say that the SEC did not raise questions about an auditor’s independence when providing tax services. The questions raised about tax services just did not survive in the final rules. At III(D)(1)(b)(xi), the proposed rules stated:

*Tax services.* The proposed rule would not affect tax-related services provided by auditors to their audit clients. Tax services are unique, not only because there are detailed tax laws that must be consistently applied, but also because the Internal Revenue Service has discretion to audit any tax return. We do not think that the Congressional purpose for requiring independent audits is thwarted by an accountant providing traditional tax preparation services to an audit client or an affiliate of an audit client. We are considering whether special considerations apply when the auditor provides a tax opinion for the use of a third party in connection with a business transaction between the audit client and the third party. . . . Under those circumstances, the auditor may be acting as an advocate. . . . We request comment on whether providing tax opinions, including tax opinions for tax shelters . . . would impair, or would appear to reasonable investors to impair, an auditor’s independence. . . . Are there other tax-related services that if provided to an audit client, would impair, or would appear to reasonable investors to impair, an auditor’s independence?<sup>26</sup>

For the Levitt reforms, the final outcome was that “special considerations” were not deemed necessary for tax services. However, Enron, WorldCom, and Tyco have shed new light on this area. The accounting problems at each of these firms involved both tax and financial statement deceptions. As a result, the SEC is revisiting the tax services issue under Sarbanes-Oxley.

*Auditor independence in the United States (post-Sarbanes-Oxley).* Section 201(a) of Sarbanes-Oxley

codified the auditor independence rules of the Levitt reforms. However, changes were made. Section 201(a) eliminates all the exceptions and limitations to prohibited services that had crept into the rules through compromise with the accounting profession.

Eliminating exceptions was more than a reaction to Enron; it constituted a change in regulatory theory. It was the first sign that Congress expected the SEC to shift the United States away from a rules-based regulatory method toward a more principles-based set of standards. The SEC observed, “We interpret the legislative history as indicating (1) Congress did not intend the rules to contain broad categorical exceptions and (2) the scope of the prohibited services should be judged against three basic principles. Those three broad principles are that an auditor cannot (1) audit his or her own work, (2) perform management functions, or (3) act as an advocate for the client. To do so would impair the auditor’s independence. . . . We assume, therefore, that Congress intended the Commission to revise its existing rules, at a minimum, to eliminate categorical exceptions and exemptions.”<sup>27</sup>

Those “three broad principles” had a history. They had been incorporated into the *preliminary note* to rule 2-01 of regulation S-X, 17 CFR 210.2-01 in the Levitt reforms. Now those proposals were to guide the SEC as it drafted new rules on auditor independence.

*Nonaudit tax services and auditor independence in the United States (post-Sarbanes-Oxley).* The SEC and the Public Company Accounting Oversight Board (PCAOB) are both moving ahead in the area of tax services. New SEC rules made tax services a suspect classification within the field of nonaudit services. Where the Levitt reforms had required registrants to report nonaudit services in aggregate,<sup>28</sup> the new SEC rules require tax services to be separately itemized.<sup>29</sup>

<sup>27</sup>SEC, *Strengthening the Commission’s Requirements Regarding Auditor Independence*, (Dec. 2, 2002) RIN 3235-AI73 at II (B). At: <http://www.sec.gov/rules/proposed/33-8154.htm>.

<sup>28</sup>“Under the final rule, we are not requiring registrants to describe each professional service or to disclose the fee for each service . . . under the caption ‘All Other Fees,’ the fees billed for all other nonaudit services, including fees for tax-related services, rendered by the principal accountant during the most recent year.” SEC, *Final Rule: Revision of the Commission’s Auditor Independence Requirements*, *supra* note 24.

<sup>29</sup>“We also believe it is appropriate to add transparency regarding a second category of fees: ‘Tax Fees.’ . . . We believe that investors will benefit from being able to consider those fees separately from the ‘All Other Fees’ category. The ‘Tax Fees’ category will capture all services performed by professional staff in the independent accountant’s tax division except those related to the audit as discussed previously. Typically, it would include fees for tax compliance, tax planning, and tax advice.” SEC, *Final Rule: Strengthening the Commission’s Requirements Regarding Auditor Independence*, (Jan. 28, 2003) at II (H). At: <http://www.sec.gov/rules/final/33-8183.htm>.

<sup>25</sup>*Id.*

<sup>26</sup>SEC, *Proposed Rule: Revision of the Commission’s Auditor Independence Requirements*, RIN 3235-AH91 (June 30, 2000). At: <http://www.sec.gov/rules/proposed/34-42994.htm>.

The PCAOB embraced the three broad principles that governed the Levitt reforms as guiding principles that would control further regulatory efforts. A July 14, 2004, roundtable was organized to solicit comments on tax services.<sup>30</sup> The following specific areas were isolated for investigation: tax compliance services; tax planning and advisory services; tax strategy services; and executive and international assignment tax services.<sup>31</sup>

Is the United States moving closer to a principles-based system of auditor independence regulation? In the area of tax services, the answer appears to be yes, but the U.S. approach remains far more detail-oriented than the EU approach. Nevertheless, steps are being taken toward global convergence.

Taken together, the actions of the Congress, the SEC, and the PCAOB seem to confirm a conscious effort to change and accommodate. Congress pushed both the SEC and the PCAOB in that direction when it required in section 108(d) of the Sarbanes-Oxley Act that a study be prepared on *The Adoption by the United States Financial Reporting System of a Principles-Based Accounting System*.

### E. Australia

*Auditor independence rules in Australia.* Australia began a comprehensive corporate law economic reform program in 1997 called the CLERP initiative. The ninth package of reforms in the initiative, referred to as CLERP 9, dealt with auditor independence: *Corporate Disclosure: Strengthening the Financial Reporting Framework*. Australia was responding to the domestic and world crisis in auditor independence standards. The ITS reform program was presented to

Parliament December 2, 2003,<sup>32</sup> well after the collapse of HIH (March 2001) and One.Tel (July 2001) and the passage of Sarbanes-Oxley (July 30, 2002) and the *Loi de Sécurité Financière* (July 17, 2003). The reforms were enacted June 24, 2004.<sup>33</sup>

CLERP 9 is based on proposals for change from three sources: the Ramsay report, *Independence of Australian Company Auditors* (October 2001);<sup>34</sup> the Joint Committee on Public Accounts and Audits *Report 391: Review of Independent Auditing by Registered Company Auditors* (September 2002);<sup>35</sup> and recommendations from the HIH Royal Commission.<sup>36</sup>

### The Australian system of auditor oversight is one of shared responsibility.

The substance of CLERP 9 is the legislative decision that auditor independence is a governmental concern as well as a concern of the accounting profession. Australian reforms are principles-based, because they adopt the rules of the profession, which, in turn, are based on international accounting standards. That approach was strongly supported by the Ramsay report, Report 391, and the HIH Royal Commission. The rules go through the familiar process of identifying and documenting threats to independence and then the auditor's safeguards to those threats.<sup>37</sup> If the auditor determines that the safeguards are ineffective, the professional standard (and now the Corporations Act) mandates prohibition.<sup>38</sup>

<sup>30</sup>Andrew Parker's article "US Regulator Close to Ban on Audit and Tax Links," in the electronic version of the *Financial Times* of November 21, 2004, indicates that the PCAOB is expected to issue proposed rules on nonaudit tax services in December 2004. In two areas nonaudit tax services are expected to be prohibited: the provision of tax services to corporate executives of the companies they audit; and the provision of "success services" or tax contingency fee arrangements. However, it is unclear if those will be the only proposed rule changes. The full scope of the anticipated rules have not been disclosed. Parker writes, "The big four accounting firms — Deloitte, Ernst & Young, KPMG and PwC — are lobbying hard for limited reform by the US regulator, partly because tax is their biggest source of income after audit. But the regulator, which has been considering the tax rules since a round-table on the issue in July, has found it difficult to define which tax avoidance strategies are abusive. As yet, no final decisions about the tax rules have been made by the PCAOB but an initial draft has been completed."

<sup>31</sup>PCAOB, *Briefing Paper: Auditor Independence and Tax Services Roundtable* (July 14, 2004). At: [http://www.pcaobus.org/Rules\\_of\\_the\\_Board/Documents/2004-07-14\\_Roundtable\\_Transcript.pdf](http://www.pcaobus.org/Rules_of_the_Board/Documents/2004-07-14_Roundtable_Transcript.pdf).

<sup>32</sup>The complete legislation package can be found at: [http://www.treasury.gov.au/documents/700/PDF/CLERP\\_Bill.pdf](http://www.treasury.gov.au/documents/700/PDF/CLERP_Bill.pdf).

<sup>33</sup>See *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004*, No. 103, 2004. At: <http://scaleplus.law.gov.au/html/comact/browse/TOCN.htm>.

<sup>34</sup>The Ramsay report can be found at: <http://www.treasury.gov.au/documents/183/PDF/ramsay.pdf>.

<sup>35</sup>See <http://www.aph.gov.au/house/committee/jpaa/independaudit/reportscript.pdf>.

<sup>36</sup>HIH Royal Commission, *supra* note 2.

<sup>37</sup>The threats to independence are self-interest, self-review, advocacy, familiarity, and intimidation. The safeguards are safeguards created by the profession, legislation, or regulation; safeguards within the client; and safeguards within the audit firm itself. See Institute of Chartered Accountants in Australia and CPA Australia, *Professional Statement F-1 (Applicable to All Members): Professional Independence*, at 1.22 to 1.37. Available at: [http://www.cpaaustralia.com.au/cps/rde/xbc/SID-3F57FEDE-D62BB915/cpa/submission\\_fl.pdf](http://www.cpaaustralia.com.au/cps/rde/xbc/SID-3F57FEDE-D62BB915/cpa/submission_fl.pdf).

<sup>38</sup>*Id.* at 2.54 to 2.101.



The Australian system of auditor oversight is one of shared responsibility; both the government and peer review structures oversee the accounting profession. Thus, ethical rules drafted by the accounting profession essentially define statutory rules for auditor independence.<sup>39</sup> CLERP 9 simply incorporates those rules into the Corporations Act, making them statutorily (as well as ethically) applicable to auditors of Australian corporations. Section 324CA presents the general requirement of auditor independence and section 324CB prohibits conflicts of interest.

The Institute of Chartered Accountants in Australia lent its support to CLERP 9 in a July 16, 2002, news release, "Australia Ahead of the Game." In the release, the Institute favorably compared the Australian principles-based approach with the United States' rules-based method and characterized Sarbanes-Oxley as a movement by the United States closer to the international norm: "[Sarbanes-Oxley is] the first step towards convergence of US standards to the development of comprehensive international accounting standards."<sup>40</sup>

*Nonaudit tax services and auditor independence in Australia.* CLERP 9 does not contain a definition of nonaudit services, much less nonaudit tax services. The law does contain a requirement that the board of directors provide a statement in the annual report that identifies all nonaudit services provided by the audit firm and the fees applicable to each item of nonaudit service (subsection 300(11A) of the Corporations Act). Also, a statement by the directors must indicate that they are satisfied that the provision of nonaudit services is compatible with the general standard of independence and an explanation of why those nonaudit services do not compromise audit independence (subsection 300(11B) of the Corporations Act).

Consideration of tax services is found outside of the act in the standards of the accounting profession. *Professional Statement F.1* contains the following:

The firm may be asked to provide taxation services to an audit client. Taxation services comprise a broad range of services including compliance, planning, provision of formal taxation opinions, and assistance in the resolution of tax disputes. Such assignments

are generally not seen to create threats to independence.<sup>41</sup>

An extended itemization of tax services is set out in appendix 1 of the *Guidance Notice*. However, the Australian rules are not very critical of tax services: All the listed services are approved. The only limitation is that the auditor must have the "appropriate experience and skills" needed to perform the tax services.<sup>42</sup>

## F. Japan

*Auditor independence rules in Japan.* Japan took an entirely different path to improving auditor independence. Seemingly immune from the wave of accounting-related corporate collapses, Japan did not implement reforms until April 2004. Japan even waited after it learned of Enron, WorldCom, HHH, One.Tel, Vivendi, Ahold, and Parmalat.

### **The nonaudit services prohibited under Japanese law are a mirror image of the nonaudit services that are prohibited under U.S. law.**

Japan responded not to accounting failures, but to the wave of overseas regulatory reforms that threatened to affect Japanese businesses and the Japanese accounting profession itself. The defining event for Japanese regulators was section 106(a) of Sarbanes-Oxley, the extraterritorial enforcement provision of the act, providing that the SEC and PCAOB are authorized to oversee foreign accounting firms if they perform statutory audits for firms listed on U.S. exchanges.<sup>43</sup> When the PCAOB initiated rulemaking

<sup>41</sup>Institute of Chartered Accountants in Australia and CPA Australia, *Professional Statement F-1 (Applicable to All Members): Professional Independence*, at 2.77, *supra* note 37.

<sup>42</sup>The listed services are: (1) acting as tax agent; (2) tax advice for income tax matters; (3) preparation of tax returns on behalf of an entity; (4) tax advisory services, for indirect taxes, for example, customs and excise, goods and services tax, sales tax, and stamp duty; (5) tax advice for transfer pricing; (6) tax advisory services for the Australian Tax Office audits; (7) tax advice for employee-specific matters, for example, employee-share schemes, fringe benefits tax, and superannuation; (8) tax advisory services for an entity's employees' tax return, for example, an overseas-based employee; (9) tax return preparation for an entity's employees; and (10) expatriate employment and relocation services, for example, employment contract advice and relocation coordination. See The Auditing and Assurance Standards Board of the Australian Accounting Research Foundation, *Auditor Independence and Other Services*, Guidance Note, March 2003 at Appendix 1, 1-2. Available at: <http://www.aarf.asn.au/docs/NewGuidanceNoteMarch2003.pdf>.

<sup>43</sup>See the comments of Naohiko Matsuo, Director for International Financial Markets, Japanese Financial Services Agency responding to the PCAOB's proposed rules on January 26, 2004. See item 6 in the zip file associated with "Rulemaking Docket Matter 013" at: [http://www.pcaobus.org/Rules\\_of\\_the\\_Board/rulemaking\\_docket.asp](http://www.pcaobus.org/Rules_of_the_Board/rulemaking_docket.asp).

<sup>39</sup>See *id.* Also see The Auditing and Assurance Standards Board of the Australian Accounting Research Foundation, *Auditor Independence*, Guidance Note, March 2003 at appendix 1, 1-2. Available at: <http://www.aarf.asn.au/docs/NewGuidanceNoteMarch2003.pdf>.

<sup>40</sup>The Institute of Chartered Accountants in Australia, *Australia Ahead of the Game*, at: <http://www.icaa.org.au/news/index.cfm?menu=269&id=A105172188>.

procedures<sup>44</sup> that would potentially bring Japanese auditing firms under direct U.S. oversight, Japan began to replace its peer review system with an independent regulatory structure.<sup>45</sup>

The PCAOB is willing to rely on investigation by non-U.S. authorities after an evaluation of the “independence and rigor” of the foreign system. Local law, the independence of the agency, its funding, transparency, and its history of performance are all considered.<sup>46</sup>

Japan’s response to Sarbanes-Oxley has two aspects. First, the Japanese legislature amended the “Certified Public Accountant Law” (*Kouninkaikeishihou* 1948-8-1) through “An Act to Amend Part of the Certified Public Accounting Law” (*Kouninkaikeishihou no ichibu wo kaisei suru houritsu* 2004-4-1). Second, the Japanese government issued Cabinet Office ordinances (*Naikakuhurei* 2004-4-1). In the law promulgated June 6, 2003, a new government oversight and inspection agency, the CPA and Auditing Oversight Board (CPAFOB) was established. In the Cabinet ordinance at article 5, rules on auditor independence were published.

### **Japan responded, not to accounting failures, but to the wave of overseas regulatory reforms.**

The Cabinet ordinance rules are a literal translation of Sarbanes-Oxley section 201(a)(1)-(8) and nothing more. Thus, the nonaudit services prohibited under Japanese law are a mirror image of the nonaudit services that are prohibited under U.S. law. The Japanese law and ordinances were effective April 1, 2004.

*Nonaudit tax services and auditor independence in Japan.* The Japanese have no rules on nonaudit tax services. Because the prohibitions of sections 201(a)(1)-(8) make no direct reference to tax services, the same is true of the Japanese law. Tax services are permitted.<sup>47</sup>

However, section 201(a)(9) of Sarbanes-Oxley grants the PCAOB discretion to extend the list of prohibited nonaudit services. According to the July 14, 2004, “Auditor Independence and Tax Services Roundtable,” the PCAOB is considering rulemaking that would directly extend these prohibitions into the tax services area. One could expect that if U.S. rules on tax services were issued, that Japan would make a similar rule change through an update to the Cabinet Ordinance. At least that would appear to be true for any tax services that the PCAOB determines should be expressly prohibited.

## **II. Signs of Convergence**

Are there signs of convergence in corporate governance on the provision of nonaudit services? The answer is yes in at least two respects.

First, there is general agreement around a common goal: the improvement of investor confidence through the increased reliability of financial statements. Second, there is remarkable consensus on the ultimate principles that need to be applied to meet that goal.

In the United States, those principles were set out in the Levitt reforms. They remain in the *preliminary note* to rule 2-01 of regulation S-X, 17 CFR 210.2-01 and were unchanged by Sarbanes-Oxley. The Japanese statement of principles follows the United States. In the European Union, United Kingdom, and Australia,<sup>48</sup> the same principles, formulated in a different manner, are expressed in terms of threats to auditor independence.<sup>49</sup>

Viewed side-by-side, the harmony in the underlying principles in those alternate formulations is apparent.

<sup>44</sup>The rules were finalized on June 9, 2004. PCAOB, *Final Rules Relating to the Oversight of Non-US Public Accounting Firms*. At: [http://www.pcaobus.org/Rules\\_of\\_the\\_Board/Documents/Release2004-005.pdf](http://www.pcaobus.org/Rules_of_the_Board/Documents/Release2004-005.pdf). They were forwarded to the SEC for final approval on June 17, 2004. At: [http://www.pcaobus.org/Rules\\_of\\_the\\_Board/Documents/Docket\\_013/PCAOB%202004-04%20Form%2019b-4%20for%20International%20Rules%20-%20June%2017%202004.pdf](http://www.pcaobus.org/Rules_of_the_Board/Documents/Docket_013/PCAOB%202004-04%20Form%2019b-4%20for%20International%20Rules%20-%20June%2017%202004.pdf).

<sup>45</sup>PCAOB, *Proposed Rules Relating to the Oversight of Non-U.S. Public Accounting Firms*, (Dec. 10, 2003). At: [http://www.pcaobus.org/Rules\\_of\\_the\\_Board/Documents/Release2003-024.pdf](http://www.pcaobus.org/Rules_of_the_Board/Documents/Release2003-024.pdf).

<sup>46</sup>PCAOB proposed rule 4012. At PCAOB, *Final Rules Relating to the Oversight of Non-U.S. Public Accounting Firms*, p. A1-2. At: [http://www.pcaobus.org/Rules\\_of\\_the\\_Board/Documents/2004-07-14\\_Roundtable\\_Transcript.pdf](http://www.pcaobus.org/Rules_of_the_Board/Documents/2004-07-14_Roundtable_Transcript.pdf).

<sup>47</sup>An indirect prohibition under Sarbanes-Oxley can be seen, for example, in the advocacy prohibition. Because advocacy (representing an audit client in court) is a prohibited activity under section 201(a)(8), so too is tax advocacy (representing an audit client in tax court).

<sup>48</sup>Because the French view is that all nonaudit services should be prohibited, France is omitted from this assessment. The French view follows that of the International Federation of Accountants. However, from the French perspective, threats to independence cannot be mitigated through any safeguard short of absolute prohibition.

<sup>49</sup>The common source for those formulations is the International Federation of Accountants, *Code of Ethics for Professional Accountants*, IFAC Ethic Committee, New York, NY (2001).

U.S.; Japan	EU; <sup>50</sup> U.K.; <sup>51</sup> Australia <sup>52</sup>
1. The auditor should have no mutual or conflicting interest with the client.	Self-interest threat. <sup>53</sup> Familiarity threat. <sup>54</sup> Intimidation threat. <sup>55</sup>
2. The auditor should not audit his or her own work.	Self-review threat (element 1). <sup>56</sup>
3. The auditor should not function as management or as an employee of the client.	Self-review threat (element 2).
4. The auditor should not act as an advocate for the client.	Advocacy threat. <sup>57</sup>

Convergence, then, is not a matter of agreeing on goals or ultimate principles; it is a matter of developing common implementation schemes and designing uniform enforcement. That is the difference. The United States has preferred rules-based standards, while most other countries have preferred principles-based standards. However, the United States

<sup>50</sup>The EU formulation can be found in the *Consultative Paper on Statutory Auditor's Independence in the EU: A Set of Fundamental Principles*, *supra* note 10.

<sup>51</sup>The U.K. framework was introduced in 1997 and was placed into conformance with the EU framework in June 2002 by adopting the "Fundamental Principles" of the European Union. See Institute of Chartered Accountants in England and Wales, *Guide to Professional Ethics: Introduction and Fundamental Principles, Statement 1.200 Revised*, (2002).

<sup>52</sup>The CLERP 9 reforms place those rules into the Corporations Act at sections 324CE(7) and 324CF(7). *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004*, *supra* note 33.

<sup>53</sup>A self-interest threat occurs when a firm or a member of the assurance team could benefit from a financial interest in, or other self-interest conflict with an assurance client." Institute of Chartered Accountants in Australia and CPA Australia, *Professional Statement F-1 (Applicable to All Members): Professional Independence*, at 1.23, *supra* note 37.

<sup>54</sup>A familiarity threat occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or a member of the assurance team becomes too sympathetic to the client's interests." *Id.* at 1.26.

<sup>55</sup>An intimidation threat occurs when a member of the assurance team may be deterred from acting objectively and exercising professional skepticism by threat, actual or perceived, from directors, officers or employees of an assurance client." *Id.* at 1.27.

<sup>56</sup>A self-review threat occurs when (1) any product or judgment of a previous assurance engagement or non-assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement, or (2) when a member of the assurance team was previously a director or officer of the assurance client or was an employee in a position to exert direct and significant influence over the matter of the assurance engagement." *Id.* at 1.24.

<sup>57</sup>Advocacy threat occurs when a firm, or a member of the assurance team, promotes, or may be perceived to promote an assurance client's position or opinion to the point that objectivity may, or may be perceived to be compromised. Such may be the case if a firm or member of the assurance team were to subordinate their judgment to that of the client." *Id.* at 1.25.

appears to be moving toward convergence. The questions that remain are: Has the United States moved far enough? If the United States has only moved halfway, and halfway is not enough, will the United States be met in the middle?

The SEC has offered an assessment of rules-based and principles-based standards. It has found both to be wanting and has proposed that rules should be written in a manner that blends rules- and principles-based methods. It calls that blend an objectives-oriented method of setting standards.<sup>58</sup> The developing U.S. rules on tax services are important because they appear to be the first comprehensive attempt to put that new approach into practice. They form the case study at the end of this paper.

### III. Principles- vs. Rules-Based Regulation

Two theories of standard-setting — principles-based and rules-based — characterize auditor independence regulation.

*Principles-based regulation.* Concise statements of substantive principles characterize principles-based rules. The regulatory objective is an integral part of the standard. The standard itself is characterized by few, if any, exceptions. Principles-based regulation commonly provides detailed implementation guidance. It is normally devoid of bright-line tests. The standard implements, is consistent with, and is derived from a coherent overall conceptual framework of corporate governance practices.

*Rules-based regulation.* In contrast, a rules-based approach to standard-setting is characterized by bright-line tests. The standards themselves frequently incorporate exceptions. Voluminous, detailed implementation guidance is usually needed to resolve uncertainties about application of the standard. The underlying vision of a rules-based system is to incorporate within the standard an examination of virtually every imaginable scenario and provide detailed guidance on the resolution of each fact pattern. In theory, that approach seeks to minimize the need for professional judgment.

*Convergence of principles-based and rules-based theories.* Aside from press statements, the best evidence that convergence efforts are underway is found in the SEC's *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the*

<sup>58</sup>SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System*. Available at: <http://www.sec.gov/news/studies/principlesbasedstand.htm>.

*United States Financial Reporting System of a Principles-Based Accounting System.*<sup>59</sup> In the study, the SEC criticizes both principles-only and rules-only standards and proposes a middle ground of objectives-oriented standard-setting.

A principles-only approach is criticized for not providing sufficient guidance to make standards reliably operational. Under a principles-only approach, "auditors are required to exercise significant judgment in applying overly-broad standards to more specific transactions and events."<sup>60</sup> The SEC saw heavy reliance on judgment as a factor that would result in a loss of comparability among reporting entities, as well as increase the likelihood of litigation.

However, the SEC also criticizes a rules-only approach: "A rules-based standard can provide a roadmap to avoidance of the accounting objectives inherent in the standards. Internal inconsistencies, exceptions and bright-line tests reward those willing to engineer their way around the intent of the standards."<sup>61</sup> The danger here is financial reporting that is not representationally faithful to the underlying economic substance of the transactions and events. The large number of exceptions in rules-based systems leads to internal inconsistencies. Considerable judgment is needed to determine where, within a myriad of exceptions, a transaction falls. A rules-based system fosters technical compliance more than sincere communication or full and fair disclosure.

*Objectives-oriented standard-setting.* The significant characteristic of an objectives-oriented standard is that it has few, if any, scope exceptions. A theory of optimal scope governs. That means that it avoids a scope that is too broad when a standard could not provide meaningful and useful guidance and avoids a scope that is too narrow when a standard would not have sufficient applicability to cover all transactions of similar economic substance.<sup>62</sup>

As envisioned by the SEC, an objectives-oriented standard would be comprised of five distinct elements:

- it would be based on a consistently applied conceptual framework;
- it would clearly state the accounting objective;
- it would provide sufficient detail and structure that the standard can be operationalized and applied on a consistent basis;

<sup>59</sup>Available at: <http://www.sec.gov/news/studies/principlesbasedstand.htm>.

<sup>60</sup>SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (July 25, 2003) at 6. See <http://www.sec.gov/news/studies/principlesbasedstand.htm>.

<sup>61</sup>*Id.*

<sup>62</sup>*Id.* at 24.

- it would minimize exceptions from the standard; and
- it would avoid use of percentage (bright-line) tests that allow financial engineers to achieve technical compliance with the standard while evading its intent.<sup>63</sup>

#### IV. Case Study of Convergence

In the narrow area of nonaudit tax services, the SEC appears to be following an objectives-oriented approach to developing standards. The global response to those rules will be a measure of the current convergence opportunity.

#### **Each of the highly publicized U.S. security scandals involved either the tax positions taken by the companies or the determination of their tax reserves.**

Tax services raise some of the most contentious auditor independence issues.<sup>64</sup> The intensity of the controversy is directly related both to how lucrative tax services have become for major accounting firms and how often the auditor's tax advice has become the source of corporate governance problems.<sup>65</sup> Each of the highly publicized U.S. security scandals involved either the tax positions taken by the companies or the determination of their tax reserves. The cases of Enron,<sup>66</sup> Tyco,<sup>67</sup> and WorldCom<sup>68</sup> are the most prominent examples. It is not surprising that the SEC

<sup>63</sup>*Id.* at 4-5.

<sup>64</sup>For a survey of the empirical literature in the United States and United Kingdom on this issue, see Vivian Beattie and Stella Fearnley, *Auditor Independence and Non-Audit Services: A Review of the Literature* (2000) at 28-30. At: [http://www.icaew.co.uk/library/index.cfm?AUB=TB21\\_63272,MNXI\\_63272](http://www.icaew.co.uk/library/index.cfm?AUB=TB21_63272,MNXI_63272). For a similar survey from an Australian perspective, see the Ramsay report, *supra* note 34.

<sup>65</sup>In a survey of SEC audit clients performed by the then Big Five audit firms, the ratio of accounting and auditing revenues to consulting revenues dropped from about 6 to 1 in 1999 to 1.5 to 1 in 1999. In 1999, 4 percent of the Big 5 firms' SEC audit clients had consulting fees in excess of audit fees, up from 1 percent in 1990. Panel on Audit Effectiveness, *Report and Recommendations*, (2000) chaired by Shaun F. O'Malley at paragraph 5.14. At: <http://www.pobauditpanel.org/download.html>.

<sup>66</sup>Peter Behr and April Witt, "Visionary's Dream Led to Risky Business: Opaque Deals, Accounting Sleight of Hand Built an Energy Giant and Ensured Its Demise," *The Washington Post*, July 28, 2002, at A-1.

<sup>67</sup>Mark Maremount and Laurie P. Cohen, "New York Prosecutors Seek Auditor Link in Tyco Probe," *Wall Street Journal Europe*, Sept. 30, 2002, at A-1.

<sup>68</sup>Carrie Johnson and Ben White, "WorldCom Arrests Made: Two Former Executives Charged With Hiding Expenses," *The Washington Post*, Aug. 2, 2002, at A-1.

requires that the fees for tax services must be separately itemized in SEC reports.<sup>69</sup>

### The Old Standard for Tax Services

On June 29, 2000, the SEC proposed a "Revision to the Commission's Auditor Independence Requirements,"<sup>70</sup> also known as the Levitt reforms. On tax services the release stated:

The proposed rule would not affect tax-related service provided by auditors to their audit clients. Tax services are unique, not only because there are detailed laws that must be consistently applied, but also because the Internal Revenue Service has discretion to audit any tax return. We do not think that the Congressional purpose for requiring independent audits is thwarted by an accountant providing traditional tax preparation services to an audit client or an affiliate of an audit client.

Functionally, the SEC was giving blanket regulatory approval to tax services, primarily because the IRS was presumed to be overseeing that compliance area.

### New Standards for Tax Services

*The Sarbanes-Oxley Act — Efforts at Convergence Legislatively: Elements 4 and 5 of an Objectives-Oriented Standard*

The fourth element of an objectives-oriented standard is that exceptions must be minimized. The fifth is that bright-line tests must be avoided. The Sarbanes-Oxley Act contributes directly to meeting both of those requirements through its modification of the Levitt regulations.

The Levitt reforms are codified in section 201(a). However, the codification omits all exceptions and limitations. Sarbanes-Oxley eliminated 26 distinct exceptions, percentage limitations, and bright-line tests, each of which had allowed financial engineers to achieve technical compliance with the standard while evading its intent.

Sarbanes-Oxley, Section 201(a)	Levitt Reforms <sup>71</sup>
(1) "bookkeeping or other services related to the accounting records or financial statements of the audit client";	"bookkeeping or other services related to the audit clients accounting records or financial statements . . . maintaining or preparing an audit client's accounting records; preparing financial statements that are filed with the Commission . . . ; preparing or originating source data underlying the audit client's financial statements." <sup>72</sup>
(2) "financial information systems design and implementation";	"Financial information systems design and implementation. Directly or indirectly operating or supervising the operation of the audit client's information system or managing the audit client's local area network. Designing or implementing a hardware or software system that aggregates source data underlying financial statements." <sup>73</sup>
(3) "appraisal or valuation services, fairness opinions, or contribution-in-kind reports";	"Appraisal or valuation services or fairness opinions. Any appraisal service, valuation service, or any service involving a fairness opinion for an audit client where . . . material to the financial statements, or where the results of these service will be audited by the accountant." <sup>74</sup>

<sup>71</sup>*Id.*

<sup>72</sup>There are two categories of exceptions at (c)(4)(i)(B) in the final rule. The first is for "emergency or other unusual situations, provided the accountant does not undertake managerial actions or make managerial decisions." The second is applicable to foreign divisions or subsidiaries. That exception allows six categories of activities, those that are: "(i) . . . limited, routine, or ministerial; (ii) . . . [when it is] impractical . . . to make other arrangements; (iii) . . . [when] the foreign division or subsidiary is not material . . . ; (iv) . . . [when] a foreign employee is not capable or competent . . . ; (v) [when] the services performed are consistent with local professional ethical rules; (vi) [when] the fees . . . do not exceed 1 [percent] of the consolidated audit fees or \$10,000."

<sup>73</sup>There are five exceptions at (c)(4)(ii)(B) in the final rule: "(1) [when] the audit client's management has acknowledged in writing . . . its responsibility to establish and maintain a system of internal accounting controls . . . ; (2) [when] the audit client's management designates a competent employee . . . with responsibility to make all management decisions . . . ; (3) [when] the audit client's management makes all management decisions with respect to design and implementation . . . ; (4) [when] the audit client's management evaluates the adequacy and results of the design and implementation . . . ; (5) [when] the audit client's management does not rely on the accountant's work as the primary basis of the design and implementation."

<sup>74</sup>There are four exceptions at (c)(4)(iii)(B) in the final rule: "(1) [when] the accounting firm's valuation expert reviews the work of the audit client . . . ; (2) [when] . . . the audit client has determined and taken responsibility for all significant assumptions and data; (3) [when] the valuation is performed in the context of the planning and implementation of a tax planning strategy or for tax compliance services; (4) [when] the valuation is for nonfinancial purposes."

<sup>69</sup>U.S. Securities and Exchange Commission, RIN 3235-AI73 *Strengthening the Commission's Requirements Regarding Auditor Independence* (January 28, 2003, release date; May 6, 2003, effective date). At: <http://www.sec.gov/rules/final/33-8183.htm>.

<sup>70</sup>SEC, *Final Rule: Revision of the Commission's Auditor Independence Requirements*, *supra* note 24.

(4) "actuarial services";	"Actuarial services. Any actuarially-oriented advisory service involving the determination of insurance company policy reserves and related accounts." <sup>75</sup>
(5) "internal audit outsourcing services";	"Internal audit services. Either of internal audit services in an amount greater than 40 [percent] of the total hours expended on the audit . . . any internal audit services, or any operational audit services." <sup>76</sup>
(6) "management functions or human resources";	"Human resources . . . <sup>77</sup> acting as a negotiator on the audit client's behalf, such as determining positions, status or title, compensation, fringe benefits or other conditions of employment . . . (management functions)." <sup>78</sup>
(7) "broker or dealer, investment adviser, or investment banking services";	"Broker dealer services. Acting as a broker-dealer, promoter, or underwriter, on behalf of a client." <sup>79</sup>
(8) "legal services and expert services unrelated to the audit";	"Legal services. Providing any legal service to a client under circumstances in which the person providing the service must be admitted to practice before courts of a US jurisdiction." <sup>80</sup>
(9) "any other service that the Board [PCAOB] determines, by regulation, is impermissible."	

<sup>75</sup>There are four exceptions at (c)(4)(iv)(B) in the final rule: "(1) [when the accountant] . . . assists management to develop appropriate methods, assumptions and amounts for policy or loss reserves . . . ; (2) [when the accountant] assists management in the conversion of financial statements . . . ; (3) [when the accountant] analyzes actuarial considerations and alternatives in federal income tax planning; (4) [when the accountant] assists management in the financial analysis of various matters, such as new policies, new markets, business acquisitions, and reinsurance needs."

<sup>76</sup>There are six exceptions at (c)(4)(v)(B) in the final rule: "(1) [when] the audit client's management has acknowledged in writing . . . its responsibility to establish and maintain a system of internal accounting controls . . . ; (2) [when] the audit client's management designates a competent employee . . . to be responsible for the internal audit function . . . ; (3) [when] the audit client's management determines the scope, risk, and frequency of internal audit activities . . . ; (4) [when] the audit client's management evaluates the findings and results arising from internal audit activities . . . ; (5) [when] the audit client's management evaluates the adequacy of the audit procedures performed . . . ; (6) [when] the audit client's management does not rely on the accountant's work as the primary basis for determining the adequacy of its internal controls."

<sup>77</sup>No exceptions.

<sup>78</sup>No exceptions.

<sup>79</sup>No exceptions.

<sup>80</sup>No exceptions.

### Tax Services in Sarbanes-Oxley

Sarbanes-Oxley places tax services under that same conceptual framework controlled by the same general principles as all other nonaudit services. The language has been problematic to some. It not only raises the possibility that tax services could be prohibited but it also expresses the opposite position — that some tax services are permissible. The law states:

A registered public accounting firm may engage in any nonaudit service, including tax services, that is not described in any of the paragraphs (1) through (9) . . . only if the activity is approved by the audit committee of the issuer.<sup>81</sup>

Distinguishing between permissible and impermissible tax services with the same principles that govern other nonaudit services is left for SEC regulation and PCAOB rulings.

#### SEC Regulation — Contributions to Convergence: Elements 1 and 2 of an Objectives-Oriented Standard

The first and second elements of an objectives-oriented standard are that the standard is based on a consistently applied conceptual framework and that it clearly states the regulatory objective.

#### The Conceptual Framework: Element 1 in an Objectives-Oriented Standard

A consistently applied conceptual framework is applied to all nonaudit services. SEC regulation makes it clear that a three-part structure is applied to determine the appropriateness of any nonaudit service. Nonaudit services are: (1) allowed and approved by the audit committee; (2) allowable but not approved by the audit committee; or (3) prohibited because they violate one or more of the governing principles.<sup>82</sup> The audit committee discriminates between audit services in categories (1) and (2) by weighing efficiency and investor protection considerations.<sup>83</sup>

That conceptual framework is consistently applied to all nonaudit services, including tax services. The SEC explains how to use the framework to determine whether a tax service is permissible under (1) or (2) above, or prohibited under (3). The decisionmaker should reason by analogy to the other prohibited

<sup>81</sup>Section 201(a) of the Sarbanes-Oxley Act.

<sup>82</sup>Wardell, Thomas, "International Accounting Standards in the Wake of Enron: The Current State of Play under the Sarbanes-Oxley Act of 2002," 28 *N.C. J. Int'l L. & Com. Reg.*, 935 (Summer, 2003); "The Good, the Bad, and Their Corporate Code of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislative Good Behavior," 116 *Harv. Law Rev.*, 2123 (May, 2003).

<sup>83</sup>Durst, Michael C., and Thomas H. Gibson, "'Audit' vs. 'Non-Audit' Tax Services under Sarbanes-Oxley." *The Tax Executive* (November-December, 2003) 474-477.

services and be guided in that analogy by an application of the regulatory objective — auditor independence.

For example, the SEC states that, because there is no bright-line excluding tax services, “merely labeling a service as a ‘tax service’ will not necessarily eliminate its potential to impair independence under Rule 2-01(b).”<sup>84</sup> The proper analysis is to observe that, because providing legal services for a client is prohibited, an auditor should understand that “representing an audit client before a tax court, district court or federal court of claims [is also prohibited].”<sup>85</sup>

#### *The Clearly Stated Objective: Element 2 in an Objectives-Oriented Standard*

The SEC also makes it clear that the same basic objectives are applicable to all nonaudit services. Those “simple principles” of auditor independence are discussed in the final regulations:

... the principles of independence with respect to services provided by auditors are largely predicated on three basic principles, violations of which would impair the auditor’s independence:

- (1) an auditor cannot function in the role of management,
- (2) an auditor cannot audit his or her own work, and
- (3) an auditor cannot serve in an advocacy role for his or her own client.<sup>86</sup>

Although presented here as three, rather than four, principles,<sup>87</sup> the SEC expressly references the basic principles of auditor independence placed by the Levitt reforms in the *preliminary note* to rule 2-01 of regulation S-X, 17 CFR 210.2-01. Senator Paul S. Sarbanes,

D-Maryland, spelled out the same standards during Senate floor debates.<sup>88</sup>

#### *PCAOB Rulemaking: Element 3 of an Objectives-Oriented Standard*

The third element in an objectives-oriented standard is that the standard must provide sufficient detail and structure so that the standard can be operationalized and applied on a consistent basis.

That aspect of an objectives-oriented standard for tax services is not finalized at the time of this writing. The PCAOB recognizes the need for added “detail and structure” in this area, and initiated a rulemaking project on July 14, 200, to “consider the impact of tax services on auditor independence.”<sup>89</sup> A roundtable was held, signaling the beginning of the rulemaking process. The PCAOB is considering rules in the following areas:

- tax compliance services (preparation of original and amended returns, planning estimated tax payments, and preparation of return extensions at all levels of government — local, state, federal, and international jurisdictions);
- tax planning and advisory services (the treatment of mergers and acquisitions, executive compensation, employee benefit plans, proposed or pending tax legislation, and international tax requirements like trade and customs duties);
- tax strategy services (tax-motivated, structured transactions that enable a company to reduce tax liability or achieve a financial accounting result); and
- executive and international assignment tax services.<sup>90</sup>

As expected, the range of opinions at the roundtable was diverse. Some argued that the auditor should be prohibited from engaging in any tax services,<sup>91</sup> while

<sup>84</sup>SEC, *Final Rule: Strengthening the Commission’s Requirements Regarding Auditor Independence*, (Jan. 28, 2003) at II (B) (11), *supra* note 29.

<sup>85</sup>*Id.*

<sup>86</sup>*Id.*, effective May 6, 2003; <http://www.sec.gov/rules/final/33-8183.htm>. See also PCAOB, *Briefing Paper: Auditor Independence Roundtable*, (July 14, 2004) at 4, *supra* note 31.

<sup>87</sup>There seems to be some ambiguity on whether there are three or four principles. In its *Briefing Paper: Auditor Independence and Tax Services Roundtable*, the PCAOB specifically recites, without comment, the “four overarching principles that inform the Commission’s application of the general standard of independence,” and in the next paragraph recites the shorter list of “three basic principles” (pp. 4-5). Perhaps the first principle, that the auditor cannot perform an activity that would create a mutual or conflicting interest between the accountant and the audit client, is deemed to be a further abstraction of the other three principles dealing with functioning as management, auditing his own work, and advocating for the client. See [http://www.pcaobus.org/Rules\\_of\\_the\\_Board/Documents/2004-07-14-Roundtable\\_Transcript.pdf](http://www.pcaobus.org/Rules_of_the_Board/Documents/2004-07-14-Roundtable_Transcript.pdf).

<sup>88</sup>Senate Report 107-205, 107th Cong., 2d Sess., July 3, 2002.

<sup>89</sup>PCAOB, *Briefing Paper: Auditor Independence and Tax Services Roundtable*, (July 14, 2004) at 3, *supra* note 31.

<sup>90</sup>*Id.* at 4-8.

<sup>91</sup>See the comments of Donald Nicolaisen, chief accountant of the SEC: “Personally, I believe that no accounting firm should be in the business of selling these kinds of tax products [highly engineered tax products] to their audit clients” (p. 12); Elliot Schwartz, Council of Institutional Investors, “We have established a very bright-line test, which is to say that, the appropriate non-audit services that an audit firm ought to provide are zero.” (p. 68); and Michael Gagnon, PricewaterhouseCoopers (Risk Compliance), “Fundamentally, I believe our tax system is, if you will, an advocacy system. . . . we would all prepare our returns in a manner that is consistent with the tax laws, but in a manner that would be designed to . . . minimize our taxes. That’s the way the system works” (pp. 121-122). Schwartz argued, “Audit firms should not be providing non-audit services to their audit clients” (p. 147). At: [http://www.pcaobus.org/Rules\\_of\\_the\\_Board/Documents/2004-07-14-Roundtable\\_Transcript.pdf](http://www.pcaobus.org/Rules_of_the_Board/Documents/2004-07-14-Roundtable_Transcript.pdf).

others argued for great latitude in the rules.<sup>92</sup> There was however, unanimous agreement that whatever rules were to be drafted, they should follow logically from the “basic principles” first set out in the Levitt reforms.<sup>93</sup>

## V. Conclusion

The United States has responded to the most serious criticisms of its rules-only-based method of setting standards. For nonaudit services generally, the United States has eliminated exceptions, limitations, bright-line rules, and percentage tests. Specifically in the area of tax services, the United States is directly tying principles with operational rules. That represents a significant movement toward a principles-based method of setting standards.

For its own part, the United States has been critical of foreign principles-only standards. In particular, the United States is critical of those regulations when they do not provide a sufficiently detailed structure, resulting in a standard that is not clearly operationalized. The SEC feels that principles-only-based rules depend too much on the exercise of individual judgment.

Like the United Kingdom, the United States believes that more direction is needed. The rules need not be as restrictive as the French envision, but they need to be considerably more specific than the rules

that have been advanced in the European Union and Australian legislation. The United States is no longer comfortable with the assumption of the Levitt regulations, an assumption that still underpins rules in the European Union, Australia, and elsewhere, that the tax authorities provide enough oversight of the auditor in tax matters so that security regulation can be relaxed.

In that context, the PCAOB's project to draft tax service rules is very important. By some accounts, those rules are expected in proposed form in December 2004. The PCAOB intends to draft rules that apply the basic principles of the Levitt reforms, within the conceptual framework established by Sarbanes-Oxley. The manner of that application is a classic example of objectives-oriented standard-setting and it signals a new direction for U.S. rulemaking. If the PCAOB accomplishes its mission and provides detailed rules for tax services without reintroducing bright-line tests, exceptions, and limitations, a significant step toward corporate governance convergence will have been taken. At least in the area of tax services, the United States will be governed by an integrated, objectives-oriented set of coordinated standards, found in statutes, regulations, and rulings that seek to assure auditor independence.

The foreign response to those efforts will be a measure of how far we have come toward convergence. ♦

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<sup>92</sup>Scott Bayless from Deloitte & Touche argued that having the auditor provide tax services would “enhance audit quality” because tax issues cannot be “decided once a year, but involve continuous consultation as the company undertakes transactions and business events during the year” (p. 41). Michael Gagnon from PricewaterhouseCoopers indicated that having the auditor provide tax services increases “transparency” and promotes “efficiency from the client’s point of view” (p. 47). Jim Brasher from KPMG added that there is an “advantage in using the auditor” to provide tax services, because the auditor “has to be approved by the audit committee” (p. 76). Tom Ochsenschlager from the American Institute of Certified Public Accountants extended that argument, noting there would be “four levels of review,” rather than just two, if the auditor performs tax services (p. 93). In the long run, that would “save costs” and make it “much more likely that you would get appropriate tax advice” (pp. 73-74). At: [http://www.pcaobus.org/Rules\\_of\\_the\\_Board/Documents/2004-07-14\\_Roundtable\\_Transcript.pdf](http://www.pcaobus.org/Rules_of_the_Board/Documents/2004-07-14_Roundtable_Transcript.pdf).

<sup>93</sup>This conclusion was reached early in the discussions. See p. 17. At: [http://www.pcaobus.org/Rules\\_of\\_the\\_Board/Documents/2004-07-14\\_Roundtable\\_Transcript.pdf](http://www.pcaobus.org/Rules_of_the_Board/Documents/2004-07-14_Roundtable_Transcript.pdf).