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AUDITOR INDEPENDENCE AND TAX SERVICES ROUNDTABLE

JULY 14, 2004

On July 14, 2004 the Public Company Accounting Oversight Board ("PCAOB" or "Board") will convene a roundtable to discuss issues relating to auditor independence and tax services. The roundtable will start at 10 a.m. and conclude at 4:30 p.m. The Board has invited representatives of accounting firms, public companies, investors, regulators, and other interested parties to participate in the roundtable discussion. This paper contains the agenda of roundtable topics.

Overview

The federal securities laws require public companies to file with the U.S. Securities and Exchange Commission ("SEC" or "Commission") financial statements audited by a public accountant that is independent of the company preparing the financial statements ("audit client" or "issuer"). To implement this statutory directive, the SEC has promulgated rules defining what it means for an auditor to be independent of his or her audit client. Prior to November 2000, the SEC auditor independence rules did not explicitly address many of the non-audit services auditors were performing. In November 2000, the SEC amended its auditor independence rules, and, in doing so, significantly revised the types of non-audit services that auditors could provide to their audit clients. In revising the rules, the SEC also introduced four overarching independence principles that the Commission will look to in determining whether a particular service or client relationship impairs the auditor's independence.

The Sarbanes-Oxley Act of 2002 ("Act") further addressed auditor independence. Specifically, Section 201(a) of the Act expressly prohibited eight types of non-audit services,^{1/} as well as any other service that the Board determines is impermissible for

^{1/} The eight specific prohibited services are: (1) bookkeeping or other services related to the accounting records or financial statements of the audit client, (2) financial information system design and implementation, (3) appraisal or valuation

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auditors^{2/} to provide to their public company audit clients. The Act further provided that "a registered public accounting firm may engage in any non-audit service, including tax services... only if the activity is approved in advance by the audit committee of the issuer."^{3/}

As mandated by the Act, the SEC, on February 5, 2003, issued new auditor independence rules, *Strengthening the Commission's Requirements Regarding Auditor Independence* ("SEC 2003 Independence Rules").^{4/} The SEC 2003 Independence Rules, which generally took effect on May 6, 2003, expressly prohibited the eight non-audit services specified in the Act. The possible restriction of tax services was heavily debated by many interested parties when the SEC was drafting these rules. Ultimately, the SEC determined not to prohibit tax services at that time, but it did caution audit committees to scrutinize the nature of the tax services that auditors might provide before approving them. Specifically, the SEC stated in its release accompanying its 2003 Independence Rules –

The Commission reiterates its long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence. Accordingly, accountants may continue to provide tax services such as tax compliance, tax planning, and tax advice to audit clients, *subject to the normal audit committee pre-approval requirements* (emphasis added)...

Nonetheless, merely labeling a service as a "tax service" will not necessarily eliminate its potential to impair independence under Rule 2-01(b). ... Specifically, accountants would impair their independence by

services, fairness opinions, or contribution-in-kind reports, (4) actuarial services, (5) internal audit outsourcing services, (6) management function or human resources, (7) broker or dealer, investment advisor, or investment banking services, and (8) legal services and expert services unrelated to the audit.

^{2/} The term *auditor* means both public accounting firms registered with the PCAOB and associated persons thereof.

^{3/} Sarbanes-Oxley Act of 2002, Section 201(a)(h).

^{4/} SEC Release No. 33-8183.

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representing an audit client before a tax court, district court, or federal court of claims. In addition, audit committees also should scrutinize carefully the retention of an accountant in a transaction initially recommended by the accountant, the sole business purpose of which may be tax avoidance and the tax treatment of which may be not supported in the Internal Revenue Code and related regulations.^{5/}

In the past year there has been extensive debate and media coverage regarding tax services, specifically tax shelters. Congress has held hearings on tax shelters, and legislation has been proposed to prevent auditors from providing tax shelter services to their audit clients. Additionally, the Internal Revenue Service has been very active in its enforcement efforts against improper tax shelters.

The Act authorized the PCAOB to establish independence standards and rules.^{6/} In April 2003, the Board adopted as its interim, transitional standards the American Institute of Certified Public Accountant's Code of Professional Conduct Rules 101, 102, 191 and interpretations as they existed on April 16, 2003 as its interim independence standards (PCAOB Rule 3600T^{7/}). The PCAOB also adopted Independence Standards Board Standard Nos. 1, 2, and 3 and Interpretations 99-1, 00-1, and 00-2 as additional interim independence standards.

In the exercise of its new responsibilities under the Act, the Board has determined that it is appropriate to consider the impact of tax services on auditor independence. The purpose of this roundtable is to review existing tax services provided by auditors to public company audit clients and to discuss the effect these services may have on the auditor's independence.

^{5/} SEC Release No. 33-8183, Section II.B.11.

^{6/} In addition, in adopting the SEC 2003 Independence Rules, the SEC noted that the Board is charged with monitoring the impact of these rules on audit quality and independence (SEC Release No. 33-8183, Sections II.C.3 & II.E).

^{7/} PCAOB Rule 3600T also notes that the interim standards do not supersede the SEC's auditor independence rules and to the extent that a provision of the SEC's rule is more restrictive (or less restrictive) than the interim standards, the auditor must comply with the more restrictive rule.

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Roundtable Agenda

I. SEC Overarching Independence Principles

The Commission's historical approach to auditor independence issues has been to emphasize that auditors must be independent of their audit clients in both fact and appearance. Reflecting this philosophy, the SEC's auditor independence requirements not only proscribe certain financial interests and business relationships with the audit client, as well as the provision of certain types of services to the audit client, but also subject all auditor conduct to a general standard of independence. Specifically, Rule 2-01(b) provides that: "The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, *or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not*, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement."^{8/} (emphasis added)

The preliminary note to this rule lists four overarching principles that inform the Commission's application of the general standard of independence to situations that are not explicitly addressed in the auditor independence rules. The principles provide that independence may be impaired if the relationship –

- creates a mutual or conflicting interest between the accountant and the audit client;
- places the accountant in the position of auditing his or her own work;
- results in the accountant acting as management or an employee of the audit client; or
- places the accountant in a position of being an advocate for the audit client.^{9/}

^{8/} 17 CFR 210.2-01(b).

^{9/} Rule 2-01 of Regulation S-X, Preliminary Note, 17 CFR 210.2-01.

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The SEC specifically stated that these principles are "general guidance and their application may depend on particular facts and circumstances. Nonetheless, we believe that these four factors provide an appropriate framework for analyzing auditor independence issues."^{10/} The SEC reiterated the importance of these guiding principles in its February 2003 rulemaking release by stating that its "principles of independence 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 client."^{11/}

In a July 2003 SEC staff memorandum accompanying a letter from SEC Chairman William Donaldson to the Consumer Federation of America, Consumers Union, Common Cause, U.S. Public Interest Research Group, and Consumer Action, the SEC staff stated that "the relationship of these underlying principles to the provision of tax services is tempered somewhat by Congress specifically describing tax services as permissible (if pre-approved by the audit committee), by the long history of auditors providing such services, by the unique set of laws and regulations that govern the provision of tax services, and by the potential for a governmental audit of each instance where the service is provided. As a result, the three principles have not been strictly applied to traditional tax services, such as tax compliance and preparation, tax planning, and the provision of tax advice."^{12/}

The following points should be considered as each specific tax service area is discussed –

- Are these overarching independence principles useful in considering the appropriateness of tax services performed by the auditor for its audit client?

^{10/} Rule 2-01 of Regulation S-X, Preliminary Note, 17 CFR 210.2-01.

^{11/} SEC Release No. 33-8183, Section II.A.

^{12/} Memorandum from Scott Taub to William Donaldson (June 24, 2003), attached to Letter from William Donaldson to Consumer Federation of America, Consumers Union, Common Cause, U.S. Public Interest Research Group, and Consumer Action (July 11, 2003).

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- Are there other overarching independence principles that should be applied to tax services?

II. Preparation of Corporate Tax Schedules and Related Documentation

Companies calculate their liability for various federal, state, and local taxes on tax schedules that form a basis for the information that supports the amounts relating to taxes that are disclosed in financial statements. In auditing the income tax accounts, the auditor is required to obtain reasonable assurance that tax accounts, that is, the tax provision, liability (or refund receivable), and deferred tax accounts, are fairly stated and that appropriate disclosures are included in the financial statements.

Discussion Question –

1. Who prepares the tax schedules and related documentation: the issuer, a third party, or a combination of professionals? Do the answers to these questions differ depending on the relative size of the company?

III. Types of Tax Services Offered by Accounting Firms

The following section of this Briefing Paper discusses various types of tax services that an accounting firm might provide. Although these services are grouped in general categories, there is overlap among the various types of tax services. The Board is interested in exploring the different types of tax services accounting firms offer and in developing a dialogue about how these services affect the auditor's independence.

A. Tax Compliance Services

Tax compliance generally involves preparation of original and amended corporate tax returns, planning for estimated tax payments, and preparation of tax return extensions. Tax compliance services also include the preparation of tax returns for applicable states and local tax jurisdictions, including payroll and sales tax returns, as well as the returns for employee benefit and similar plans.

Discussion Questions –

2. If a public company does not have the in-house expertise to prepare tax returns and related documents, are there benefits to the company and its

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investors to engage the auditor to perform such work? Are there disadvantages to engaging a tax specialist other than the auditor?

3. What kinds of fee structures are used for tax compliance services?

B. Tax Planning and Advice Services

Tax planning and advice includes advice related to treatment of mergers and acquisitions, executive compensation, employee benefit plans, proposed or pending tax legislation, and international tax requirements (such as trade and customs duties). Many accounting firms also offer a variety of state and local tax services, such as advice on how to minimize liability for state and local taxes, tax consulting services to obtain tax refunds, tax planning for state and local tax credits and incentives, document searches for unclaimed property, and tax advice on tax assessments for property.

Discussion Questions –

4. Are there benefits to the issuer and its investors to engage the auditor to perform such work? Are there disadvantages to engaging a tax specialist other than the auditor?
5. What kinds of fee structures are used for tax planning and advice services?

C. Tax Strategy Services

Tax strategy services include the development of tax-motivated, structured transactions – or "tax product" – to enable a company to reduce its liability to pay a tax or to achieve a financial accounting result. Accountants have played a role in providing such services by designing a tax strategy or product and/or providing an opinion on whether a strategy or product is consistent with the tax requirements and/or accounting principles. Accountants have also, at times, marketed these strategies and/or products to their audit and non-audit clients.

Discussion Questions –

6. Does an accounting firm's sale of tax strategies or tax products to audit clients affect the firm's independence from the audit client? Are there

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different independence considerations depending on whether the tax strategy or product is designed to reduce tax liability or to achieve a financial statement result?

7. If the IRS or other tax regulator challenges a tax strategy designed or marketed by the issuer's auditor, what, if any, should the auditor's role be in resolving the challenge?
8. Is it appropriate for the auditor to audit the financial statement effects of a tax strategy the auditor's firm sold to the company? If another firm sold the company the tax strategy, are there independence implications if the auditor's firm markets the same strategy to other companies?

D. Executive and International Assignment Tax Services

Accounting firms may provide services to executives of audit clients in connection with the preparation of personal income tax returns and tax planning. Accounting firms also provide specialized tax services to employees who participate in an international assignment program. These services include home and host country tax compliance assistance, comprehensive tax planning, tax consulting on global stock option plans, financial planning for expatriates, estate planning for expatriates, global visa solutions, and tax equalization design and administration.

Discussion Questions –

9. Does providing tax services to audit client executives and other members of management affect an auditor's independence from the company? Does the answer depend on whether the executives are involved in the financial reporting process or otherwise making representations to the auditor?
10. Does providing tax services to employees who participate in long-term international assignments affect an auditor's independence?

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E. Other Tax Services

Discussion Question –

11. Are there tax services, not previously discussed, that could affect an auditor's independence?

IV. Relationship Between Audit and Tax Practices

In some small firms, such as sole practitioner firms, audit personnel have expertise in both auditing and in tax. In many other firms, especially large firms, there are separate tax and audit practices.

Discussion Question –

12. Is it appropriate to have tax specialists on engagement teams to examine tax accruals, structured transactions and other tax-related accounting matters? If a firm uses a specialist from its tax practice to audit tax accounts, how should the engagement team supervise and otherwise relate to the specialist? Should such a specialist's advancement, compensation, and other rewards be tied to the quality of his or her audit work?

V. Independence in Fact and Appearance and Auditor Ethics

It is important for the auditor to not only be independent in fact, but also be independent in appearance. Regardless of how well the auditor performs the audit, investors will not have confidence in the quality of the audit if they do not believe the auditor is independent. Furthermore, investors may question whether it is ethical for the auditor to provide a particular service even if a service does not impair the auditor's independence in fact or appearance.

Discussion Questions –

13. Do any of the services discussed today raise specific concerns about the auditor's appearance of independence?

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14. Do any of these services discussed today raise specific concerns about auditors' business ethics?
15. Are there any special factors audit committees should take into consideration before approving an engagement of an auditor to perform any of the services discussed today?
16. Are there other ethical issues an audit firm should consider before providing tax planning, advice, strategy, and other tax services?

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