Staff Note: There is a typographical error in Proposed Rule 3522(a) and 3522(b) on page A-5 of Release No. 2004-015. The citation in Proposed Rule 3522(a) should read 26 C.F.R 1.6011-4(b)(2) and the citation in Proposed Rule 3522(b) should read 26 C.F.R 1.6011-4(b)(3). We regret any inconvenience this may have caused.

PCAOB
Public Company Accounting Oversight Board

1666 K Street, NW
Washington, D.C. 20006
Telephone: (202) 207-9100
Facsimile: (202)862-8430
www.pcaobus.org

PROPOSED ETHICS AND INDEPENDENCE RULES CONCERNING INDEPENDENCE, TAX SERVICES, AND CONTINGENT FEES	PCAOB Release No. 2004-015 December 14, 2004 PCAOB Rulemaking Docket Matter No. 017

Summary: The Public Company Accounting Oversight Board ("PCAOB" or "Board") is proposing rules to promote the ethics and independence of registered public accounting firms that audit and review financial statements of U.S. public companies. The proposed rules would treat a registered public accounting firm as not independent of an audit client if the firm, or an affiliate of the firm, provided any service or product to an audit client for a contingent fee or a commission, or received from an audit client, directly or indirectly, a contingent fee or commission. The proposed rules also would treat such a firm as not independent if the firm, or an affiliate of the firm, provided assistance in planning, or provided tax advice on, certain types of potentially abusive tax transactions to an audit client or provided any tax services to certain senior officers of an audit client. Further, the proposed rules would require registered public accounting firms to provide certain information to the audit committee of an audit client in connection with seeking pre-approval to provide non-prohibited tax services to the audit client.

In addition to these proposed rules relating to tax services, the Board also is proposing a general rule requiring registered public accounting firms to be independent of their audit clients throughout the audit and professional engagement period. Finally, the Board is proposing a rule on the responsibility of associated persons not to cause registered public accounting firms to violate the Sarbanes-Oxley Act of 2002 (the "Act"), the rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Securities

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and Exchange Commission issued under the Act, and professional standards.

Public Comments: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, DC 20006. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 017 in the subject or reference line and should be received by the Board no later than 5:00 p.m. (EST) on February 14, 2005.

Board Contacts: Bella Rivshin, Assistant Chief Auditor (202/207-9180; rivshinb@pcaobus.org), Greg Scates, Associate Chief Auditor (202/207-9114; scatesg@pcaobus.org).

* * *

I. Background

Independent auditors of public companies serve a critical public function. Investors, creditors, and others rely on the competence and ethics of the accountants who audit the financial statements of public companies. In recognition of its public responsibilities, the auditing profession has long held itself to certain ethical standards.[1/] Foremost among these ethical standards is the mandate that the auditor must be independent of his or her audit client.[2/] As described by the Securities and Exchange Commission ("SEC" or "Commission") –

[1/] The profession's principles of professional conduct state that, "[m]embers should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism." American Institute of Certified Public Accountants ("AICPA") *Professional Standards*, "Code of Professional Conduct" ("AICPA Code of Professional Conduct"), ET § 53.

[2/] See AICPA Code of Professional Conduct, ET §§ 53, 101.

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> The independence requirement serves two related, but distinct, public policy goals. One goal is to foster high quality audits by minimizing the possibility that any external factors will influence an auditor's judgments . . . . The other related goal is to promote investor confidence in the financial statements of public companies. Investor confidence in the integrity of publicly available financial information is the cornerstone of our securities markets. Capital formation depends on the willingness of investors to invest in the securities of public companies. Investors are more likely to invest, and pricing is more likely to be efficient, the greater the assurance that the financial information disclosed by issuers is reliable. The federal securities laws contemplate that that assurance will flow from knowledge that the financial information has been subjected to rigorous examination by competent and objective auditors.
>
> The two goals – objective audits and investor confidence that the audits are objective – overlap substantially but are not identical. Because objectivity rarely can be observed directly, investor confidence in auditor independence rests in large measure on investor perception.[3/]

Accordingly, the profession's Statement on Auditing Standards ("SAS") No. 1, *Codification of Auditing Standards and Procedures*, emphasizes that auditors "should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence."[4/] The United States Supreme Court has recognized this point as well –

> The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the Nation's industries. It is therefore not enough that financial

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[3/] Revision of the Commission's Auditor Independence Requirements, SEC Release No. 33-7919 (Nov. 21, 2000).

[4/] SAS No. 1, *Codification of Auditing Standards and Procedures*, AU § 220.03. The standard further states that "[p]ublic confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence." Id.

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> statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. . . . If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.[5/]

The federal securities laws reflect, and implicitly codify, this professional obligation by requiring public companies to file with the SEC financial statements audited by a public accountant that is independent of the company preparing the financial statements. To implement these requirements, the SEC has promulgated rules defining what it means for an auditor to be independent of his or her audit client.[6/]

[5/] United States v. Arthur Young & Co., 465 U.S. 805, 819 n.15 (1984) (emphasis in original).

[6/] Prior to November 2000, the SEC auditor independence rules did not explicitly address many of the non-audit services that auditors were performing for audit clients. 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. See Revision of the Commission's Auditor Independence Requirements, SEC Release No. 33-7919 (Nov. 21, 2000). In that rulemaking, among other things, the SEC examined the new types of services that accounting firms had developed over time and evaluated the impact of those services on the objectivity of the traditional auditor's report. In addition, the SEC modernized its rules on financial interests in, and employment relationships with, audit clients to address the new business models that the largest firms had established; added an express prohibition on auditors receiving contingent fees from their audit clients; and adopted a new disclosure framework to provide investors with information about the types of non-audit services public companies were hiring their auditors to perform. In revising the rules, the SEC also introduced four overarching independence principles that it will look to in determining whether a particular service or client relationship impairs the auditor's independence. Specifically, the SEC looks to whether a relationship or the provision of a service: (a) creates a mutual or conflicting interest between the accountant and the audit client; (b) places the accountant in the position of auditing his or her own work; (c) results in the accountant acting as management or an employee of the audit client; or (d) places the accountant in a position of being an advocate for the audit client. See 17 C.F.R. § 210.2-01, Preliminary Note.

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Following the financial reporting scandals related to Enron, WorldCom, and other widely owned companies, the U.S. Congress also addressed auditor independence in the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act" or "the Act").[7/] A Senate report related to the Act recognized the importance of this issue as it relates to restoring public confidence by stating –

> The issue of auditor independence is at the center of this legislation. Public confidence in the integrity of financial statements of publicly-traded companies is based on belief in the independence of the auditor from the audit client.[8/]

In establishing the PCAOB, the Sarbanes-Oxley Act vested in the PCAOB the authority to establish standards relating to auditor ethics and independence in the practice of public company auditing. Specifically, Section 103(a) of the Act directs the Board, by rule, to establish "ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by th[e] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." Moreover, Section 103(b) of the Act directs the Board to establish such rules on auditor independence "as may be necessary or appropriate in the public interest or for the protection of investors, to implement, or as authorized under, Title II of th[e] Act."[9/]

[7/] Pub. L. No. 107-204, 116 Stat. 745 (2002).

[8/] S. REP. No. 107-205, at 14 (2002).

[9/] Pursuant to this authority, in April 2003, the Board adopted as its interim, transitional, independence standards (PCAOB Rule 3600T) the AICPA Code of Professional Conduct Rules 101 and 102 and related interpretations and rulings thereof, as they existed on April 16, 2003. PCAOB Rule 3600T notes that the interim standards do not supersede the Commission's auditor independence rules and, to the extent that a provision of the Commission's rules is more restrictive (or less restrictive) than the interim standards, the auditor must comply with the more restrictive rules. The PCAOB also adopted Independence Standards Board ("ISB") Standard Nos. 1, 2, and 3 and Interpretations 99-1, 00-1, and 00-2 as additional interim independence standards.

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Title II of the Act addresses auditor independence. Section 201(a) of the Act expressly prohibits eight types of non-audit services, as well as any other service that the Board determines is impermissible for auditors to provide to their public company audit clients.[10/] The Act further provides 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."[11/]

As directed by the Act, the SEC on February 5, 2003, adopted new independence rules in order to implement Title II of the Act ("2003 independence rules").[12/] These rules, which generally took effect in May 2003, address key aspects of auditor independence with special emphasis on the provision of non-audit services. The rules expressly prohibit eight categories of non-audit services, as required by Section 201 of the Act.[13/] The SEC's rules also implement the Act's requirement, in Section 202, that all auditing and non-audit services be pre-approved by the company's audit committee.

Neither the Act nor the SEC's rules prohibit tax services that are pre-approved by the company's audit committee (unless those services also fall into one of the

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[10/] See Sarbanes-Oxley Act, Section 201(a). The eight specifically prohibited services are: (1) bookkeeping or other services related to the accounting records or financial statements of the audit client, (2) financial information systems design and implementation, (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports, (4) actuarial services, (5) internal audit outsourcing services, (6) management functions or human resources, (7) broker or dealer, investment adviser, or investment banking services, and (8) legal services and expert services unrelated to the audit. See id.

[11/] Id.

[12/] See Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Release No. 33-8183 (Jan. 28, 2003).

[13/] See supra note 10. Section 201 of the Act also authorizes the Board to add to the Act's eight categories of prohibited non-audit services. See Sarbanes-Oxley Act, Section 201(a).

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categories of expressly prohibited services).[14/] Rather, the Act expressly recognizes that accountants "may engage in any non-audit service, including tax services," that do not fall into one of the prohibited categories, provided that each service is approved in advance by the audit committee.[15/] The SEC's adopting release accompanying its 2003 independence rules noted that there had been considerable debate regarding whether an accountant's provision of tax services for an audit client could impair the auditor's independence. The SEC determined that it would not prohibit tax services, however, partly because audit firms – both large and small – have historically played a part in return preparation and have advised their clients on the complexities of the tax code and how it affects the client's tax liabilities.[16/] Thus, the Commission stated "that an accounting firm can provide tax services to its audit clients without impairing the firm's independence . . . [and] 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 . . . ."[17/]

While the SEC made clear that it did not consider conventional tax compliance and planning to be a threat to auditor independence, it distinguished such traditional services from the marketing of novel, tax-driven financial products. Thus, the SEC's release cautioned that audit committees should "scrutinize carefully" the retention of the auditor in a transaction initially recommended by the auditor "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."[18/]

[14/] The SEC's adopting release emphasized that the nature of the service being provided must be analyzed and that "merely labeling a service as a 'tax service' will not necessarily eliminate its potential to impair independence under Rule 2-01(b)." Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Release No. 33-8183, § II.B.11 (Jan. 28, 2003).

[15/] Sarbanes-Oxley Act, Section 201(a).

[16/] See Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Release No. 33-8183, § II.B.11, note 103 (Jan. 28, 2003).

[17/] Id. § II.B.11.

[18/] Id. Moreover, the release referred to the recommendation of the Conference Board's Commission on Public Trust and Private Enterprise that, as a "best

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Since the SEC issued its new rules, two types of tax services have raised serious concerns from investors, auditors, regulators, and others relating to the ethics and independence of accounting firms that provide both auditing and tax services. First, the Internal Revenue Service ("IRS") and the Department of Justice have brought a number of cases against accounting firms in connection with those firms' marketing of tax shelter products and, specifically, those firms' alleged failures to register, or comply with list maintenance requirements relating to, their tax shelter products. In addition, in November 2003, the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs held hearings on tax shelters[19/] in which the subcommittee elicited testimony that described certain potentially abusive tax shelter products marketed through cold-call selling techniques by accounting firms and others. Apart from any problems associated with non-compliance with applicable tax laws and the concomitant erosion of public confidence in the fairness of the U.S. system of taxation, these matters have called into question the ethics of accounting firms that offer these services. To the extent that such firms audit public companies, these potential ethical issues threaten to undercut efforts to restore investor confidence in the objectivity, integrity, and reliability of public company auditing.

Second, audit firms have been criticized for providing tax services, including tax shelter products, to senior executives of their public company audit clients. Some have questioned whether an auditor's provision of such services to the executives overseeing its audit client's financial reporting could lead to conflicts of interest.[20/] At a minimum, such practices have raised serious appearance issues that contribute to the erosion of public confidence in the objectivity of the auditor and, by extension, the reliability of

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practice," auditors not provide advice on "novel and debatable" tax strategies and products. Id. § II.B.11 at note 112.

[19/] U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals: Hearings Before the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs, 108th Cong., 1st Sess, S. Hrg. 108-473 (2003); see also S. REP. No. 108-34 (2003).

[20/] See, e.g., Kathleen Pender, Double Standard at Sprint, S.F. CHRON., May 13, 2003, at B1.

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audited financial statements.[21/] The SEC staff has noted these concerns and recommended that audit committees scrutinize audit firms' provision of these services –

> The provision of tax services to the executives of an audit client is not expressly addressed in the Act or in the Commission's rules. Nonetheless, an audit committee should review the provision of those services to assure that reasonable investors would conclude that the auditor, when providing such services, is capable of exercising objective and impartial judgment on all issues within the audit engagement.[22/]

It also has become apparent that certain fee arrangements used for the provision of tax services may not be in compliance with the SEC's requirements. In particular, it has recently come to light that a professional association may have been misinterpreting the SEC's contingent fee rule.[23/]

Specifically, the American Institute of Certified Public Accountants ("AICPA") recently asserted that the SEC's rule prohibiting contingent fees is consistent with an AICPA interpretation of the AICPA's own contingent fee rule. The AICPA relied on the

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[21/] Jeremy Kahn, Do Accountants Have a Future?; The last thing the Big Four needed was yet another scandal. But they've got one - this time over tax shelters, Fortune, March 3, 2003, at 115.

[22/] Memorandum from Scott A. Taub, Deputy Chief Accountant, Office of the Chief Accountant, U.S. Securities and Exchange Commission (June 24, 2003), at 5 ("Taub Memo"), attached to letter from Chairman William H. Donaldson, U.S. Securities and Exchange Commission, to Five Consumer Groups (July 11, 2003).

[23/] The SEC's rule on contingent fees, similar to the AICPA's rule, provides that –

> An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides any service or product to an audit client for a contingent fee or a commission, or receives a contingent fee or commission from an audit client.

17 C.F.R. § 210.2-01(c)(5).

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incorporation into the SEC's rule of an exception for fees that are "determined based on the results of judicial proceedings or the findings of governmental agencies." While both the AICPA and SEC rules contain such an exception, the AICPA interpreted that exception to mean that an AICPA member has not violated the contingent fee rule if "the member can demonstrate a reasonable expectation at the time of a fee arrangement of substantive consideration by an agency with respect to the members' client."[24/]

In a May 21, 2004 letter on this issue, the Chief Accountant of the SEC pointed out that neither the SEC's rule nor its accompanying release refers to the AICPA's interpretation and that "the Commission had in mind a much different test for the application of this exception."[25/] The letter further stated –

> [T]he exception in the Commission's rule is not based on whether the accountant reasonably expects a government agency would consider issues with respect to its audit client. The release makes clear that the exception would apply only when the determination of the fee is taken out of the hands of the accounting firm and its audit client and is made by a body that will act in the public interest, with the result that the accounting firm and client are less likely to share a mutual financial interest in the outcome of the firm's advice or service.[26/]

[24/] Letter from Bruce P. Webb, Chair, Professional Ethics Executive Committee, American Institute of Certified Public Accountants, to Douglas Carmichael, Chief Auditor and Director of Professional Standards, Public Company Accounting Oversight Board, at 1 (April 30, 2004) (available at www.aicpa.org/download/ethics/2004_0430_Carmichael.pdf); see also AICPA Code of Professional Conduct, Interpretation No. 302-1, "Contingent Fees in Tax Matters," of ET § 302, *Contingent Fees*.

[25/] Letter from Donald T. Nicolaisen, Chief Accountant, Office of the Chief Accountant, U.S. Securities and Exchange Commission, to Bruce P. Webb, Chair, Professional Ethics Executive Committee, American Institute of Certified Public Accountants, dated May 21, 2004 (available at www.sec.gov/info/accountants/staffletters/webb052104.htm) ("Nicolaisen Letter").

[26/] Id.

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Thus, the SEC rule would not permit certain contingent fee arrangements that would be allowed under the AICPA's interpretation.

Finally, in addition to these new questions that have arisen after the SEC issued its rules to implement Title II of the Act, issuers have begun to publish their policies on pre-approval of non-audit services, including tax services, by the audit committee. Specifically, under the SEC's rules implementing Title II of the Sarbanes-Oxley Act, an accountant is considered not to be independent of a public company audit client unless, either –

> (A) Before the accountant is engaged by the issuer or its subsidiaries . . . to render audit or non-audit services, the engagement is approved by the issuer's . . . audit committee; or
>
> (B) The engagement to render the service is entered into pursuant to pre-approval policies and procedures established by the audit committee of the issuer . . . ; provided the policies and procedures are detailed as to the particular service and the audit committee is informed of each service and such policies and procedures do not include delegation of the audit committee's responsibilities under the Securities Exchange Act of 1934 to management . . . .[27/]

In general, many of these policies provide for an annual review of audit and non-audit services by the audit committee, which includes review of a schedule, or budget, of non-audit services anticipated in the coming year. The SEC staff has said that, under the SEC's Rule 2-01(c)(7) –

> To the extent any schedule or cover sheet for a category of services is provided to the committee for its administrative convenience, that schedule or cover sheet must be accompanied by detailed backup documentation that spells out the terms of each non-audit service to be provided by the auditor that is being pre-approved by the audit committee. Such documentation should be so detailed that there should never be any doubt as to whether any particular service was brought to the audit

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[27/] 17 C.F.R. § 210.2-01(c)(7).

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committee's attention and was considered and pre-approved by that committee.[28/]

Although registered public accounting firms play a significant role in facilitating audit committees' consideration of non-audit services, the Board's rules do not yet include general auditor requirements relating to the Act's and the SEC's new pre-approval requirements.[29/] The proposed rules would implement these requirements as they relate to the provision of tax services to an issuer audit client.

The PCAOB has the authority and the responsibility to establish ethics and independence standards to enhance the quality and reliability of the audits of public company financial statements. Over the last several months, the Board has evaluated whether an auditor's provision of tax services, or any class of tax services, to an audit client impairs the auditor's independence from that audit client, in fact or appearance. As part of this evaluation, the Board held a public roundtable discussion with individuals representing a variety of viewpoints, including investors, auditors, managers of public companies, governmental officials, and others.[30/] In the context of this evaluation, the

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[28/] Taub Memo, supra note 22, at 3; see also SEC Office of the Chief Accountant: Application of the January 2003 Rules on Auditor Independence Frequently Asked Questions ("FAQs"), Audit Committee Pre-approval, Answer No. 24, issued August 13, 2003. The SEC's FAQ answer states that "[p]re-approval policies must be designed to ensure that the audit committee knows precisely what services it is being asked to pre-approve so that it can make a well-reasoned assessment of the impact of the service on the auditor's independence. For example, if the audit committee is presented with a schedule or cover sheet describing services to be pre-approved, that schedule or cover sheet must be accompanied by detailed back-up documentation regarding the specific services to be provided" (available at www.sec.gov/info/accountants/ocafaqaudind080703.htm).

[29/] The Board's Auditing Standard No. 2, paragraph 33, however, does provide that an "auditor must not accept an engagement to provide internal control-related services to an issuer for which the auditor also audits the financial statements unless that engagement has been specifically pre-approved by the audit committee."

[30/] The Board held the Auditor Independence Roundtable on Tax Services (the "Roundtable") on July 14, 2004. A list of Roundtable participants can be found at

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Board has considered a wide range of tax services, including routine tax return preparation and tax compliance; tax planning and advice relating to federal, state, local, and other tax laws; executive tax services; international assignment tax services; and tax shelter strategies and products.

On the basis of this evaluation, the Board has developed proposed rules designed to address the ethical problems posed by registered firms' involvement in two areas – the provision of advice on tax positions that may be abusive and tax compliance and planning services for certain senior officers, i.e., those in a financial reporting oversight role. To the extent that auditors' provision of other tax services to public company audit clients is consistent with the Commission's independence requirements,[31/] the Board's proposed rules would not prohibit registered public accounting firms from providing those services to their audit clients, subject to the Act's and the Commission's requirements relating to audit committee pre-approval of such services.

In determining whether to propose restrictions on specific types of tax services, the Board considered such services in light of the Commission's rules on auditor independence, including specifically Rule 2-01(b), and the four principles set forth in the Preliminary Note to that rule.[32/] 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

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pages 2 and 3 of the transcript of the Roundtable (available at www.pcaobus.org/Rules_of_the_Board/Documents/2004-07-14_Roundtable_Transcript.pdf).

[31/] For example, as the Commission stated in its release accompanying its 2003 independence rules, "[i]t would not be appropriate to provide a prohibited service, label it as a 'tax service,' and argue that it is, therefore, permissible." Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Release No. 33-8183, § II.B.11, note 111 (Jan. 28, 2003).

[32/] In addition, the Board took into consideration the Commission's rule treating an auditor as not independent if it "performs any decision-making, supervisory or ongoing monitoring function for the audit client." 17 C.F.R. § 210.2-01(c)(4)(vi).

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> that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement.[33/]

The Preliminary Note to Rule 2-01 provides, among other things, that –

> Section 210.2-01(b) sets forth the general standard of auditor independence. Paragraphs (c)(1) to (c)(5) [on prohibited services] reflect the application of the general standard to particular circumstances. The rule does not purport to, and the Commission could not, consider all circumstances that raise independence concerns, and these are subject to the general standard in § 210.2-01(b). In considering this standard, the Commission looks in the first instance to whether a relationship or the provision of a service: 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.[34/]

As the Commission's Preliminary Note indicates, predicting whether particular services in particular circumstances would cause a reasonable investor to believe the objectivity and impartiality of an auditor was impaired is a complex task, and it is one that may change over time. The following discussion is intended to provide registered firms and their audit clients with an indication of how the Board has analyzed these concepts as applied to some fairly typical types of tax services and explains why the Board has determined at this time to propose restrictions only in two particular areas. Specifically, tax services that the Board has considered and determined not to propose prohibiting include –

Routine Tax Return Preparation and Tax Compliance. Many issuers have in-house compliance employees who perform much or most of the compliance function. Registered public accounting firms and other consultants often are employed to render services in conjunction with these functions, including preparation of original and amended corporate tax returns, planning for estimated tax payments, and preparation of

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[33/] 17 C.F.R. § 210.2-01(b).

[34/] Id. § 210.2-01, Preliminary Note.

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tax return extensions. In addition, firms may provide assistance in the preparation of tax returns for applicable state and local tax jurisdictions, including payroll and sales tax returns, as well as the returns for employee benefit and similar plans.

As a general matter, routine tax return preparation and tax compliance services have not raised independence concerns. In the case of most tax compliance services, the auditor does not prepare tax returns until after management has calculated and allocated its tax liability and the auditor has audited the income tax accounts to obtain reasonable assurance that they are fairly stated and are accompanied by appropriate disclosure. Also, in preparing a tax return, the auditor is not acting as an advocate for its client. These services remain subject to the Commission's general standard of auditor independence in Rule 2-01(b) and its requirement that all non-audit services be pre-approved by an audit client's audit committee, the application of one or both of which is likely to identify any unique circumstances in a particular engagement that could present an independence concern. Therefore, at this time, a *per se* prohibition on such services appears to be unnecessary and inappropriate.

General Tax Planning and Advice. Research and tax planning in connection with routine and even non-routine business transactions initiated by the audit client generally have not raised auditor independence concerns, except in the case of aggressive strategies, and so long as the management of the audit client makes all decisions relating to, and takes responsibility for, both the tax work and the presentation of tax-related accounts and other matters in the financial statements.[35/] For example, these types of routine services do not appear to create the mutuality of interest that exists with regard to aggressive tax transactions. A tax accountant rendering planning advice often works with the client to structure an activity or transaction to secure the most tax-effective result or to establish appropriate characterization and reporting of activities or transactions that have already occurred. Either type of service can range from a technical explanation of a non-controversial "black-and-white" area of tax law to an evaluation of the likelihood that an interpretation of a "gray area" would be sustained in litigation or, if not, that it might lead to the imposition of penalties. The form of this tax advice also can range from phone calls, e-mails, and informal memoranda to formal written opinions to provide support in a tax audit or to avoid the imposition of penalties.

Given the breadth of such tax planning and advice services that accounting firms offer, it is difficult to apply a bright-line test to these services. As in the case of all non-

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[35/] See supra note 32.

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audit services, the Commission's Rule 2-01(b) would still treat an auditor as not independent if "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 . . . ."[36/] Nor may an auditor characterize a prohibited service, such as bookkeeping or advocacy, as a tax service in order to avoid the Commission's prohibitions.[37/] Therefore, except in the case of aggressive tax transactions, there does not appear to be a need to prohibit *per se* registered firms from providing tax planning and advice to their audit clients.

International Assignment Tax Services. Accounting firms routinely provide assistance to companies in preparing home and host country tax returns and other forms for employees on international assignment. These services typically are paid for by the company, as a means of minimizing the company's risk that its employees will embarrass the company in a foreign country that hosts the company. Because the company pays for the services, they are subject to the Act's and the Commission's requirements relating to audit committee pre-approval and to proxy fee disclosure requirements. The Board's evaluation has not identified independence or ethical issues when an accounting firm provides these routine tax return preparation services to its audit clients, so long as the accounting firm does not perform bookkeeping services related to such tax work or hold or transfer funds for the company or its employees, which are prohibited functions under the Commission's independence rules.[38/]

Employee Personal Tax Services. Like international assignment tax services, registered firms' provision of personal tax services for employees of their audit clients has not raised significant independence concerns, except for personal tax services for officers who function in a financial reporting oversight role at the audit client. Accordingly, the Board's proposed rules to restrict auditors from providing personal tax services to audit client employees are limited to those officers who serve in a financial reporting oversight role.

[36/] Id. § 210.2-01(b).

[37/] See supra note 31.

[38/] See 17 C.F.R. § 210.2-01(c)(4)(i). Officers who are on an international assignment and function in a financial reporting oversight role will not be able to have the issuer's auditor perform their tax compliance and tax return preparation because they fall under the Board's proposed Rule 3523 criteria, however.

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The Board invites comment on this discussion. In particular, the Board seeks comment on whether any of the types of services discussed in this section of the release raise independence concerns the Board has not identified. The Board also seeks comment on whether there are other types of tax services that could appropriately be included in this discussion.

II. Underlying Objectives of the Board's Proposed Rules

The Board's proposed rules are intended to accomplish four objectives. First, the proposed rules would codify, in an ethics rule, the principle that persons associated with a registered public accounting firm should not cause the firm to violate relevant laws, rules, and standards. Second, the proposed rules introduce a foundation for the independence component of the Board's ethics rules. That foundation includes a fundamental independence requirement and, as necessary and appropriate, additional rules addressing specific circumstances related to independence issues.

Third, the proposed rules would build on that foundation with rules that identify certain impairments to an auditor's independence. Specifically, the proposed rules would treat a firm as not independent if it entered into contingent fee arrangements relating to its audit clients. Also, the proposed rules would treat a registered public accounting firm as not independent if the firm, or any of its affiliates, planned, opined on, or marketed certain tax transactions to audit clients. In addition, the Board's proposed rules would treat a registered public accounting firm as not independent if the firm, or any of its affiliates, provided tax services to officers in a financial reporting oversight role of an audit client.

Fourth, the proposed rules would require registered public accounting firms to provide certain information in connection with seeking pre-approval from the audit committee to perform non-prohibited tax services for the audit client. The proposed rules would require such firms seeking pre-approval to provide the audit committee with proposed engagement letters and detailed backup information and to engage in a substantive discussion with the audit committee about the potential effects of such services on the firm's independence.[39/]

[39/] The proposed rules also include several definitions that are integral to the operation of the rules.

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A. Responsibility Not to Cause Violations

Proposed Rule 3502 provides that a person associated with a registered public accounting firm shall not cause that firm to violate the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards, due to an act or omission the person knew or should have known would contribute to such violation. While certain types of violations, by their nature, may give rise to direct liability only for a registered public accounting firm, the firm's associated persons bear an ethical obligation not to be a cause of any violations by the firm. Proposed Rule 3502 would codify that obligation and would make it clear that the obligation is enforceable by the Board. Proposed Rule 3502 also makes clear that an associated person's ethical obligation is not merely to refrain from knowingly causing a violation but also to act with sufficient care to avoid negligently causing a violation.[40/]

Proposed Rule 3502 not only appropriately would codify an ethical obligation of associated persons of registered firms, but it is also inherent in, and necessary to, the Board's authority to enforce PCAOB standards, rules, and related laws against both registered firms and their associated persons. A registered firm, whether in the form of a partnership, a professional corporation, or otherwise, can only act through the natural persons who serve as its agents, including its associated persons. When one or more of those associated persons has caused that firm to violate PCAOB rules, standards, or related laws with the requisite state of mind, it is appropriate, and consistent with the Board's duty to discipline registered firms and their associated persons under Section

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[40/] The phrase "knew or should have known would contribute to such violation" in proposed Rule 3502 is intended to articulate a negligence standard. Cf. KPMG LLP v. Sec. and Exch. Comm'n, 289 F.3d 109, 120, 126 (D.C. Cir. 2002). In addition, in cases in which a person has caused a violation in circumstances meeting the higher thresholds in Section 105(c)(5) of the Sarbanes-Oxley Act (i.e., intentional or knowing conduct, including reckless conduct, or repeated instances of negligent conduct), the more severe sanctions in Section 105(c)(4)(A) through (C) and (D)(ii) of the Act could also be imposed. See Sarbanes-Oxley Act, Section 105(c)(5). Indeed, Section 105(c)(5) expressly provides that those more severe sanctions may be imposed when intentional, knowing, or reckless conduct, or repeated instances of negligent conduct, "[results] in violation of law", regulations, or professional standards. Id.

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101(c)(4) of the Act, that the Board be able to discipline the associated person for that misconduct.

While proposed Rule 3502 would apply in other contexts as well, the Board is proposing the rule at this time, and as part of this rulemaking, because it is essential to the proper functioning of the Board's independence rules. As discussed in Section B1, Rule 3520 requires registered firms to be independent of their audit clients. When an associated person negligently causes the registered firm to not be independent, Rule 3502 would allow the Board to discipline that associated person for that action.

The Board invites comments on any aspect of proposed Rule 3502 and encourages commenters to consider certain issues in particular. First, are there categories of circumstances encompassed by the rule as proposed that should not be encompassed by the rule for some reason? Second, in a circumstance in which a firm is found to have committed a violation that requires that the firm knowingly or recklessly engaged in the misconduct, would it be appropriate to find a Rule 3502 violation by an associated person who negligently contributed to the violation?

B. Ethics and Independence

The proposed rules create a foundation for the independence component of the Board's ethics rules for registered public accounting firms and their associated persons. The proposed rules introduce a new "Independence" subpart in the ethics rules. That subpart begins with proposed Rule 3520, which articulates the fundamental independence requirement. The proposed rules also include additional rules that describe independence impediments in the particular context of contingent fee arrangements and tax services, respectively.

1. The Fundamental Independence Requirement

Proposed Rule 3520 sets forth the fundamental ethical obligation of independence: a registered public accounting firm must be independent of its audit client throughout the audit and professional engagement period. This requirement encompasses the independence requirements set out in PCAOB Rule 3600T and goes further, as a matter of the auditor's ethical obligation, to encompass any other independence requirements applicable to the audit in the particular circumstances.

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Accordingly, in the case of an audit client subject to the financial reporting requirements of the Securities Exchange Act and the Commission's rules, a registered public accounting firm's ethical obligation under proposed Rule 3520 requires the firm to maintain independence consistent with the Commission's independence requirements. That is, with respect to an issuer audit client, the ethical obligation in proposed Rule 3520 requires an auditor to maintain independence in accordance with the terms of, among other things, Rule 2-01 of the Commission's Regulation S-X.[41/]

By giving this scope to proposed Rule 3520, the Board is not promulgating any new independence requirement. The Commission's independence requirements exist independently of Rule 3520 and are subject to change at the discretion of the Commission, without Rule 3520 purporting separately to lock in place any aspect of those requirements. Instead, Rule 3520 is based on the simple premise that rules of good conduct for auditors can and should encompass a duty by the auditor to maintain independence necessary to insure compliance with independence requirements in the circumstances of the particular engagement.

A note to the proposed rule emphasizes the scope of the obligation in the rule by pointing out that, even in circumstances to which the Commission's Rule 2-01 applies, a registered public accounting firm still may need to comply with other independence requirements, specifically those requirements separately established by the Board. Using the foundation of the proposed rules, the Board may adopt additional rules in the "Independence" subpart of the ethics rules that effectively set out additional requirements. As described below, the current proposed rules include only additional requirements addressing contingent fee arrangements and tax services.

The Board invites comments on any aspect of proposed Rule 3520, and encourages commenters to consider one issue in particular. Would the scope of the ethical obligation described above impose any practical difficulties? Commenters who foresee any such difficulties are encouraged to describe in detail any ways in which the proposed scope of the rule would cause or require auditors to follow any different practices and procedures than they currently follow to comply with existing legal requirements.

[41/] See 17 C.F.R. § 210.2-01.

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2. Contingent Fees

Proposed Rule 3521, adapted from the Commission's rule on contingent fees, would treat registered public accounting firms as not independent of their audit clients if they enter into contingent fee arrangements with those clients.[42/] Specifically, proposed Rule 3521 would provide that a registered public accounting firm is not independent of its audit client[43/] if the firm, or any affiliate of the firm,[44/] during the audit and professional

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[42/] See id. § 210.2-01(c)(5).

[43/] Proposed Rule 3501(a)(iv) would define "audit client" as "the entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of the audit client." This proposed definition is substantially similar to the SEC's definition of "audit client" in Rule 2-01 of the Commission's Regulation S-X. See 17 C.F.R. § 210.2-01(f)(6). The proposed definition does not include a clause that appears at the end of the SEC's definition of "audit client" that has significance only in the context of the SEC's financial relationship rules. The term "affiliates of the audit client" would itself be defined in a manner that generally includes entities in a control relationship with the audit client, entities over which the audit client has significant influence unless immaterial, or that have significant influence over the audit client unless immaterial, and, in the context of investment companies, each entity in the "investment company complex." The term "investment company complex" is itself defined in proposed Rule 3501(i)(i). The proposed definitions of both "affiliate of the audit client" and "investment company complex" are verbatim the SEC's definitions of these same terms and should be understood to cover the same entities that would be covered by these terms in applying the SEC's independence rules. See id. § 210.2-01(f)(14).

[44/] Proposed Rule 3501(a)(i) would define "affiliate of the accounting firm" as "the accounting firm's parents; subsidiaries; pension, retirement, investment or similar plans; and any associated entities of the firm, as that term is used in Rule 2-01 of the Commission's Regulation S-X, 17 C.F.R. § 210.2-01(f)(2)." This definition is intended to cover the same affiliates considered to be part of the accounting firm for purposes of complying with the SEC's independence rules. To clarify the scope of the term, the proposed definition would explicitly refer to the concept of an accounting firm's "associated entities" under the SEC's independence rules. See also PCAOB Rule 1001(a)(iv) (defining the term "associated entity" in the context of the Board's other rules in a manner consistent with the SEC's use of the term). The Commission has not

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engagement period,[45/] provided any service or product to the audit client for a contingent fee or a commission, or received from the audit client, directly or indirectly, a contingent fee or commission. Proposed Rule 3501(c)(i) would define a contingent fee as "any fee established for the sale of a product or the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service." Under the proposed rule, the term "contingent fee" should be understood broadly to include the aggregate amount of compensation for a service, including any payment, service, or promise of other value, taking into account any rights to reimbursements, refunds, or other repayments that could modify the amount received in a manner that makes it contingent on a finding or result.

Fees fixed by courts or other public authorities and not dependent on a finding or result would be excluded from this definition to recognize and permit contingencies that do not pose a risk of establishing a mutual interest between the auditor and the audit

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defined this term, although it has issued guidance indicating what factors will be looked at in determining if an entity is associated with an accounting firm. See SEC Office of the Chief Accountant: Application of Revised Rules on Auditor Independence FAQs, Answer No. 17, issued January 16, 2001 (explaining the staff's approach to this issue and referring readers to the guidance in notes 489 and 491 in the Commission's adopting release in its 2001 Independence Rulemaking; Revision of the Commission's Auditor Independence Requirements, SEC Release No. 33-7919 (Nov. 21, 2000)). Wholly apart from the Board's incorporation of this concept in the proposed rule, all registered public accounting firms auditing companies subject to the Commission's financial reporting requirements already need to know who their associated entities are in order to comply with the Commission's independence requirements.

[45/] Proposed Rule 3501(a)(iii) would adapt the definition of "audit and professional engagement period" from the definition of that term in the Rule 2-01 of the Commission's Regulation S-X, which includes both the period covered by the financial statements under audit or review and the period beginning when a registered public accounting firm signs, or submits to the audit client, an engagement letter (or when such a firm begins audit, review or attest procedures, whichever is earlier) and ends when the audit client notifies the SEC that the engagement has ceased. See 17 C.F.R. § 210.2-01(f)(5).

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client. For example, when an audit client is the subject of a bankruptcy proceeding, the bankruptcy court must approve the auditor's fees for any services.[46/] Accordingly, the exception would permit fees that are contingent on "the amount [being] fixed by courts or other public authorities and not dependent on a finding or result."[47/] Although the approval of a bankruptcy court is the most obvious contingency that may be imposed on auditors' fees from audit clients, the proposed exception extends to other "courts or other public authorities." The Board invites comment as to whether there are courts or other public authorities that fix fees that are not dependent on a finding or result, other than bankruptcy courts, such that the term "courts or other public authorities" is necessary.

Although proposed Rule 3521 and the related definition of "contingent fee" are modeled on the SEC's independence rules, they differ from those rules in important respects. The principal difference is that the definition would eliminate the exception in the text of the SEC's rule for fees "in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies."[48/] As discussed above, this exception may have been misinterpreted by the AICPA to allow contingent fee arrangements when "the member can demonstrate a reasonable expectation, at the time of a fee arrangement, of substantive consideration by an agency with respect to the member's client."[49/] The SEC Chief Accountant has noted that "[t]he release makes clear that the exception would apply only when the determination of the fee is taken out

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[46/] See 11 U.S.C. § 328 (providing that, with a bankruptcy court's approval, a bankruptcy trustee may employ a professional person "on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, or on a contingent fee basis"). Although proposed Rule 3521, together with the proposed definition of "contingent fee" set forth in proposed Rule 3501(c)(i), would permit a registered public accounting firm to provide services for a fee that is contingent on a bankruptcy court's approval, they effectively would prohibit such a firm from arranging for a bankruptcy trustee to seek bankruptcy court approval of a contingent fee.

[47/] Proposed Rule 3501(c)(i)(2).

[48/] 17 C.F.R. § 210.2-01(f)(10).

[49/] AICPA Code of Professional Conduct, Interpretation No. 302-1, "Contingent Fees in Tax Matters," of ET § 302, *Contingent Fees*.

of the hands of the accounting firm and its audit client and is made by a body that will act in the public interest."[50/] In light of the history of the possible misinterpretation of this exception, and the fact that the remaining exception for fees "fixed by courts or other public authorities" appears adequately to identify those contingent fees that pose lesser independence risks, proposed Rule 3521 would eliminate the "tax matters" exception.[51/]

In addition, proposed Rule 3521 would expressly treat a firm as not independent of an audit client if it received a contingent fee or commission from that client "directly or indirectly." The proposed rule would include the term "directly or indirectly" to signal that the rule is intended to discourage efforts to apply the rule in a formalistic manner or to seek to avoid application of the rule through use of intermediaries. Accordingly, the proposed rule should be understood to treat a registered public accounting firm as not independent of an audit client if the firm, or any affiliate of the firm, receives a fee from *any* person that is contingent on a finding or result attained by the audit client or otherwise related to the firm's services for the audit client.

Finally, like the Commission's independence rules, proposed Rule 3521 would treat contingent fee arrangements between a registered public accounting firm's affiliates and the registered public accounting firm's audit clients as relevant to the firm's independence.[52/] The inclusion of such affiliates within the scope of those persons

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[50/] Nicolaisen Letter, supra note 25.

[51/] By eliminating this exception from its contingent fee rule, the Board expresses no view on any accounting firm's compliance with Rule 2-01 of the Commission's Regulation S-X. See 17 C.F.R. § 210.2-01(c)(5).

[52/] The proposed rule would do so by providing that the firm is not independent if it "or any affiliate of the firm . . . provides any service or product to the audit client for a contingent fee or a commission, or receives from the audit client, directly or indirectly, a contingent fee or commission." The scope of the proposed rule is intended to be the same as the scope of the Commission's rule, which defines the terms "accountant" and "accounting firm" to include such affiliates. Because registration with the Board is the basis for the Board's authority over an accountant, the proposed rules would treat those persons that are related to a registered public accounting firm and satisfy the Commission's definition of "accounting firm," but are not registered firms themselves, as "affiliates of the accounting firm." Thus, proposed Rule 3501(a)(i) would adapt the Commission's definition of the term "accounting firm" to define the term

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whose activities may impair the independence of the registered public accounting firm from an audit client is intended to prevent frustration of the rule's purpose through the use of firm subsidiaries and other affiliates.[53/] The proposed rule is not intended to, and does not, impose any requirements on affiliates of firms *per se*. Nonetheless, the conduct of an affiliate of the firm can cause the registered firm not to be independent in the situations specified in the rules.

3. Aggressive Tax Positions

Proposed Rule 3522 would, in effect, prohibit auditors from providing services, other than auditing services, related to planning or opining on the tax consequences of certain transactions that pose special challenges to an auditor's independence. Specifically, proposed Rule 3522 would treat a registered public accounting firm as not independent from an audit client if the firm, or an affiliate of the firm, provided services related to planning or opining on the tax consequences of a transaction that is a listed or confidential transaction under United States Department of Treasury ("Treasury") regulations or that promotes an interpretation of applicable tax laws for which there is inadequate support. Like proposed Rule 3521 on contingent fees, proposed Rule 3522 would treat a registered public accounting firm as not independent of its audit client if the firm, or an affiliate of the firm, provided any service described in the proposed rule.

"affiliate of the accounting firm" as "the accounting firm's parents, subsidiaries, pension, retirement, investment or similar plans, and any associated entities of the firm, as that term is used in Rule 2-01 of the Commission's Regulation S-X, 17 C.F.R. § 210.2-01(f)(2)."

[53/] See, e.g., In re PricewaterhouseCoopers LLP, & PricewaterhouseCoopers Securities LLC, AP 3-10835 (July 17, 2002) (finding an auditing firm and an affiliate under the control of the firm in violation of Commission requirements because the affiliate performed investment banking services for the firm's audit clients for contingent fees); see also KPMG LLP v. Sec. & Exch. Comm'n, 289 F.3d 109 (D.C. Cir. 2002) (declining to find an audit firm in violation of the AICPA's rule prohibiting contingent fee arrangements with audit clients, where the audit firm only indirectly received a contingent royalty from an audit client, through an associated entity of the audit firm and an audit client of the firm). Although the D.C. Circuit declined to find KPMG responsible under the AICPA rule for the contingent fee arrangement between its associated entity and its audit client, the proposed rules should be understood to treat such an arrangement as an impairment of a registered public accounting firm's independence.

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Proposed Rule 3522 is intended to describe a class of tax-motivated transactions that present an unacceptable risk of impairing an auditor's independence if the auditor participates in the transaction in any capacity other than as an auditor. The participants in the Board's July 14, 2004, Auditor Independence Roundtable encouraged the Board to prohibit auditors from marketing, advising, or opining on abusive tax avoidance transactions on the ground that such conduct has seriously damaged investors' confidence in the judgment and objectivity of firms that engage in such transactions. For example, the Chief Accountant of the SEC stated that –

> Tax services have been a fundamental part of the accounting firms since the inception of the profession. In recent years, however, the nature and extent of these services changed. Firms began formulating highly engineered tax products that were not designed for a particular client, but, instead, were marketed to numerous potential buyers, with the firm taking a percentage of each buyer's profits from the product. Over time, the IRS and others have found several of these products to be overly aggressive, or outright abusive, tax shelters. Personally, I believe that no accounting firm should be in the business of selling these kinds of tax products to their audit clients. [54/]

Further, aggressive tax positions, often called strategies or tax shelter products, carry a high risk that taxing authorities will not allow the position taken by the auditor and the

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[54/] Remarks of Donald Nicolaisen, Chief Accountant, Office of the Chief Accountant, U.S. Securities and Exchange Commission, Roundtable Tr. at 12-13; see also Remarks of Michael Gagnon, PricewaterhouseCoopers LLP, Roundtable Tr. at 101 (stating that tax advantage strategies "impacts a firm's independence and not in a positive way" and "encourag[ing] a reconsideration" of the current independence rules that leave consideration of such strategies to audit committees, on the ground that "from an integrity perspective" such transactions are inappropriate); Remarks of Mark Weinberger, Ernst & Young LLP, Roundtable Tr. at 107 ("I would agree that the rule that's currently out there, which says that there should be careful scrutiny of these transactions where sole motivation is tax aid without business purpose, could go further and it should be banned frankly from audit firms providing it to their audit clients or others."); Remarks of James Brasher, KPMG LLP, Roundtable Tr. at 103 ("[A]uditing firms should not sell tax strategies to an audit client that lack business purpose and economic substance.").

audit client. As the SEC Chief Accountant noted in the context of contingent fees, "the fact that a government agency might challenge the amount of the client's tax savings . . . heightens . . . the mutuality of interest between the firm and client."[55/]

In order to describe this class of transactions in a manner that is clear and consistent with existing foundations for analyzing tax-oriented transactions, the proposed rule is adapted from certain IRS regulations and from the Commission's release accompanying its 2003 independence rules. For example, proposed Rules 3522(a) and (b) provide that transactions "listed" by the IRS, or that are substantially similar to such transactions, or that are required to be reported to the IRS as "confidential transactions," are within the class of transactions that impair an auditor's independence if the auditor participates in them in any capacity other than as the auditor.

a. Listed Transactions

Proposed Rule 3522(a) would treat a registered public accounting firm as not independent of its audit client if the firm, or any affiliate of the firm, provided services related to planning, or opining on the tax treatment of, a listed transaction. Under the regulations of the IRS and the Treasury, a listed transaction is "a transaction that is the same as or substantially similar to one of the types of transactions that the Internal Revenue Service (IRS) has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction."[56/] The IRS utilizes its listing program to identify and publish on its list those transactions that tax promoters and advisors have developed and sold to clients but that, in the IRS's view, do not comply with applicable Internal Revenue Code ("Code") provisions and regulations.

The IRS's ability to discover and analyze new tax strategies places it in a good position to identify types of transactions that rely on questionable interpretations of the Code. Once the IRS lists a type of transaction, the Treasury's regulation on "reportable transactions" requires taxpayers to disclose such transactions as part of their federal tax returns to alert the IRS that such taxpayers have engaged in transactions that the IRS

[55/] Nicolaisen Letter, supra note 25.

[56/] 26 C.F.R. § 1.6011-4(b)(2).

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may want to review or audit. In addition, "material [tax] advisors," as described under Treasury regulations, are now required to file disclosure statements concerning such transactions.[57/] Thus, the Treasury's regulation on "listed transactions" identifies a class of transactions that, in the Board's view, carry an unacceptable risk of disallowance by the IRS, which in turn could create an unacceptable risk of establishing a mutuality of interest between the auditor and the audit client if the auditor participated in planning or opining on the transaction that impairs independence. By referring to this class of transactions, the Board's proposed Rule 3522(a) would incorporate an existing framework that auditors who serve as tax advisors already follow in their tax practices and that is highly likely to remain current since the Treasury and the IRS regularly update guidance related to listed transactions.[58/]

Proposed Rule 3522(a) is narrowly tailored to describe a class of potentially abusive transactions that auditors ought not to participate in, other than to audit them. Because the risk of IRS scrutiny of listed transactions, including transactions that are substantially similar to listed transactions, is high, tax advisors and taxpayers tend not to enter into such transactions once they are listed. So long as a transaction is not listed, or is not substantially similar to a listed transaction, at the time it is executed, the independence of a firm that plans or opines on the transaction will not *per se* be impaired under Rule 3522(a). Nevertheless, firms should be cautious in participating in transactions that the firms believe could become listed.

Furthermore, even if a firm's independence was intact at the time the transaction was executed because it reasonably and correctly concluded the transaction was not the same as, or substantially similar to, a listed transaction, once a transaction is actually listed (or a substantially similar transaction becomes listed), a firm that has participated in the transaction may find its independence impaired due to the mutuality of interest caused by the listing. In such cases, the auditor should carefully consider the

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[57/] See The American Jobs Creation Act of 2004 ("Jobs Act"), Pub. L. No. 108-357, 188 Stat. 1418, § 815 (2004); see also IRS Notice 2004-80.

[58/] The IRS updates the list of listed transactions by issuing a listing notice, both adding and removing transactions from the list of listed transactions. See e.g., IRS Notice No. 2004-67, 2004-41 I.R.B. 600.

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potential impairment of its independence with the audit committee of its audit client.[59/] For example, once a transaction is listed, either the audit client or the firm, or both, may be required to defend the tax treatment of the transaction and, in some cases, pay penalties.[60/] In addition, the firm may face liability to the audit client related to the firm's tax advice. The auditor's judgment regarding appropriate financial reporting and disclosure concerning a transaction that becomes listed could become biased easily by the auditor's vested interests in defending its tax advice.

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 comment on whether the rule should address the possible impairment of an auditor's independence in such situations. The Board also seeks comment, more generally, on whether proposed Rule 3522(a) adequately describes a class of transactions that carry an unacceptable risk of impairing an auditor's independence.

[59/] According to ISB Standard No. 1, which is incorporated in the Board's Rule 3600T on interim independence standards, at least annually, an auditor must "disclose to the audit committee of the company (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence." (available at www.cpaindependence.org).

[60/] The Treasury's regulations impose on taxpayers a continuing obligation to report transactions that become listed after they have been entered into, until the period of limitations on the final tax return has expired. See 26 C.F.R. § 1.6011-4(e)(2)(i). Senior Treasury and IRS officials have expressed an intention vigorously to challenge abusive tax avoidance transactions. See Prepared Testimony of Commissioner of Internal Revenue Mark W. Everson before the Permanent Subcommittee on Investigations, Senate Governmental Affairs Committee Hearing on Abusive Tax Shelters, November 20, 2003; Statement of Treasury Assistant Secretary for Tax Policy Mark Weinberger on Treasury's Plan To Combat Abusive Tax Avoidance Transactions, March 20, 2002 ("The Treasury Department and the IRS are working to re-deploy additional resources to deal with tax avoidance transactions and have increased their coordination with the Department of Justice.").

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b. Confidential Transactions

The Treasury has identified transactions with tax-advisor-imposed conditions of confidentiality as potentially abusive. By regulation, the Treasury requires taxpayers to disclose to the IRS transactions in which a tax advisor "places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies."[61/] Tax-advisor-imposed confidentiality may also be indicative of a tax product that a tax advisor intends to market to multiple customers, thus necessitating commitments by customers to treat the tax treatment or tax structure of the advisor's product as confidential.

The Board is concerned that the marketing of tax products that require confidentiality in order that the firm can offer them to multiple clients contributes to the erosion of public confidence in the ethics and integrity of such firms. In addition, such transactions can form a mutuality of interest between a registered public accounting firm that markets such transactions and audit clients that purchase the transaction. If an audit client purchased such a tax product from its auditor, the firm could find itself in the conflicted position of defending the tax treatment of the product at the same time that it is passing judgment on the financial reporting treatment of the product. A reasonable investor easily could infer that the auditor has a vested interest in advocating to the IRS the tax treatment it promoted to multiple clients and perpetuating that treatment in the audit client's financial statements. Based on these concerns, proposed Rule 3522(b) would treat a registered public accounting firm as not independent of its audit client if the firm, or an affiliate of the firm, provided services related to planning, or opining on the tax consequence of, a transaction for an audit client under terms that satisfy the definition of "confidential transaction" under the Treasury regulation on reportable transactions.[62/]

[61/] 26 C.F.R. § 1.6011-4(b)(3)(ii).

[62/] In addition, the proposed Rule would treat a registered firm as not independent of its audit client if the firm, or an affiliate of the firm, provided such services in connection with a transaction that would be a confidential transaction if the tax advisor had been paid the "minimum fee" specified in the Treasury's regulation. Treasury Regulation 1.6011-4(b)(3) provides that "a confidential transaction is a transaction that is offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a minimum fee." 26 C.F.R. § 1.6011-4(b)(3). Under the regulation, the "minimum fee" is $250,000 for corporate taxpayers (and partnerships

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The Board seeks comment on whether confidential transactions should be treated as *per se* impairments of a registered public accounting firm's independence from an audit client. More broadly, the Board also seeks comment on whether other provisions of the Treasury's regulation on reportable transactions – that is, other than the provisions on listed and confidential transactions included here – should be incorporated by reference in the Board's rules on tax-oriented transactions that impair independence.

c. Aggressive Tax Positions

In addition to the provisions on listed and confidential transactions adapted from the regulatory framework for disclosure of transactions to the IRS, proposed Rule 3522 also includes a provision that would treat a registered public accounting firm as not independent if the firm, or an affiliate of the firm, provides services, other than auditing services, related to planning or opining on a transaction that is based on an aggressive interpretation of applicable tax laws and regulations. Specifically, proposed Rule 3522(c) would treat such a firm as not independent if the firm, or an affiliate of the firm, provided an audit client any service related to planning, or opining on the tax consequence of, a transaction that satisfies three criteria –

- the transaction was initially recommended by the registered public accounting firm or another tax advisor;
- a significant purpose of the transaction is tax avoidance; and
- the proposed tax treatment of the transaction is not at least more likely than not to be allowed under applicable tax laws.

Proposed Rule 3522(c) is adapted from the Commission's guidance to audit committees in its release accompanying its 2003 independence rules, which, as discussed above, cautioned that audit committees should "scrutinize carefully" the

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and trusts in which all of the owners or beneficiaries are corporations) and $50,000 for all other transactions. Id. § 1.6011-4(b)(3)(iii). The Board understands the IRS disclosure rules to serve a different purpose than the proposed Rule 3522(b). The Board does not believe that the amount paid in connection with an auditor's provision of a confidential transaction bears on the auditor's independence, in fact or appearance. Accordingly, the Board's proposed Rule 3522(b) would apply to confidential transactions, irrespective of whether they meet the Treasury regulation's minimum fee.

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retention of the auditor "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."[63/] The proposed rule would build on this guidance from the perspective of the registered public accounting firm, by providing that a registered public accounting firm is not independent of its audit client if the firm, or its affiliates, participated in such a transaction. The Board proposes to modify certain aspects of the SEC's release text, in part for clarity and in part for reasons of policy.

The first prong of the proposed rule's test looks for transactions that the auditing firm or another tax advisor initially recommended.[64/] In this manner, the proposed rule would exclude from its scope those transactions that the audit client itself, or a party other than a tax advisor[65/] (e.g., an acquiring corporation), initiated.[66/] The term "initially recommended" is intended to be a test based on fact. Under the proposed rule, the auditor would have an affirmative duty to ascertain that the transaction was not recommended initially by the firm or tax advisor. Thus, the prong would be satisfied, notwithstanding a representation from the audit client that the audit client initiated the development of the transaction, if reasonable, good faith diligence by the auditor would have revealed that the auditor or another tax advisor initially recommended it.

[63/] Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Release No. 33-8183, § II.B.11 (Jan. 28, 2003).

[64/] Cf. Remarks of Nick Cyprus, Interpublic Group, Roundtable Tr. at 104 ("I think anything that puts the auditor in the [role] of . . . originating [a] tax strategy . . . for a company, I think it's a problem."); Remarks of Colleen Saylher, Financial Executives International, Roundtable Tr. at 119-120 (arguing that "it's not appropriate to use your auditor for designing and marketing with respect to tax strategies . . . .").

[65/] The term "tax advisor" is not intended to denote a group with a certain license or professional status, but rather to cover any party outside the audit client that recommends a tax transaction to the audit client.

[66/] Cf. Remarks of Nick Cyprus, Interpublic Group, Roundtable Tr. at 138-139 ("[A]s long as the auditor is independent, in other words, they didn't create the strategy, they didn't create the tax planning itself, but they're consulting on it, they're giving [the audit client] advice on it in the same way [the audit client would] get accounting advice.").

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Proposed Rule 3522(c) would tailor the second and third prongs to incorporate concepts that have existing meaning and relevance in the context of the field of tax advisors. Accordingly, the second prong of the test set forth in proposed Rule 3522(c) would use the phrase "significant purpose of which is tax avoidance," adapted from the Internal Revenue Code and the Treasury's regulations.[67/] The term "tax avoidance" should be understood to include acceleration of deductions into earlier taxable years and deferral of income inclusion to later taxable years.

In addition, the proposed rule would use the term "more likely than not to be allowed under applicable tax laws," which is the standard taxpayers must meet, under Treasury regulations, to avoid penalties for substantial understatement of income tax due in connection with a tax shelter.[68/] Proposed Rule 3522(c) is intended to provide registered public accounting firms more clarity and predictability as to the types of transactions that impair independence. This proposed prong is based, in part, on the Board's observation of some firm policies that rely on the "more likely than not" standard to approve the firm's involvement in providing tax service relating to a transaction initiated by the firm. The proposed rules also use this standard because a tax treatment that is not "more likely than not" to be allowed poses a significantly higher risk of being challenged by the IRS or other taxing authorities, such that a mutuality of interest

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[67/] The Internal Revenue Code treats transactions with respect to which a "significant purpose . . . is the avoidance or evasion of Federal income tax" as tax shelters, for purposes of determining whether heightened accuracy-related penalties on underpayments of tax should be imposed. See 26 U.S.C. § 6662(d)(2)(C) (amended by the Jobs Act; see also 26 U.S.C. § 6662A(b)(2)(B) (imposing 20-percent penalty on understatements of tax in connection with "any reportable transaction (other than a listed transaction) if a significant purpose of such transaction is the avoidance or evasion of Federal income tax"); 26 U.S.C. § 6111(d)(1)(A) (superseded by amendment by the Jobs Act; defining confidential corporate tax shelters as transactions "significant purpose . . . of which is the avoidance or evasion of Federal income tax"); Joint Committee on Taxation, Background and Present Law Relating to Tax Shelters, at 31 (JCX-19-02, March 19, 2002) (explaining that whether a "significant purpose of [an] arrangement is the avoidance or evasion of Federal income tax by a corporate participant" is one of three criteria for identifying tax shelters for purposes of the tax shelter promoter registration requirements).

[68/] See 26 C.F.R. § 1.6664-4(f).

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between the auditor and the audit client could arise.[69/] The proposed rules also use this standard, as opposed to a higher standard, in recognition of the fact that tax laws may often be complex and subject to differing good faith interpretations.

In order to satisfy proposed Rule 3522(c)'s "more likely than not" standard, a registered public accounting firm would have to establish, based on its analysis of the pertinent facts and authorities, that there is a greater than 50-percent likelihood that the tax treatment of the transaction would be upheld if challenged by the IRS.[70/] Thus, if an auditor's judgment were unreasonable under the circumstances that existed at the time the auditor provided the tax service, or were reached in bad faith, then the standard under proposed Rule 3522(c) would not be met. The Board would not, however, treat an auditor as not independent if the law changed after the service was provided or if the tax treatment simply turned out to be not allowed.

The proposed rules do not require a registered public accounting firm to obtain a third-party opinion that a tax treatment is "more likely than not" to be allowed under applicable tax laws. On the contrary, while a firm may decide for its own reasons to obtain a third-party opinion, such an opinion would not relieve the firm of its obligation to form its own judgment on the likelihood of a proposed tax treatment to be allowed.[71/]

[69/] See Remarks of Nick Cyprus, Interpublic Group, Roundtable Tr. at 123 (objecting to the practice of audit firms' opining on transactions "[w]hen you think you will not prevail with the service and it's less than a 50 percent chance").

[70/] Cf. 26 C.F.R. § 1.6664-4(f)(2)(i)(B)(1) (incorporating by reference methodology set forth in 26 C.F.R. 1.6662-4(d)(3)(ii) for analysis of whether a tax treatment has "substantial authority" or, in the case of tax shelters, is "more likely than not" the proper treatment, for purposes of determining whether a penalty may be due on a substantial understatement of income tax). The Board seeks comment on whether the analysis described in the Treasury's regulations provides useful guidance on the application of proposed Rule 3522(c).

[71/] Treasury regulations permit corporations to avoid penalties for substantial understatement of income taxes in connection with tax shelters if they "reasonably rel[y] in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities . . . and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue

Finally, although the SEC's release accompanying its 2003 independence rules only cautioned audit committees to scrutinize situations in which a proposed tax treatment might not be supported "in the Internal Revenue Code and related regulations," the proposed rule would use the term "applicable tax laws" in recognition of the variety of tax laws and regulations, including federal, state, local, foreign, and other tax laws.

The Board invites comments on any aspect of proposed Rule 3522(c) and encourages commenters to consider certain issues in particular. First, is the term "initially recommended by the registered public accounting firm or another tax advisor" sufficiently clear? Is there a better way to describe aggressive tax transactions, strategies, and products that a registered public accounting firm ought not to sell to an audit client? Second, does the "more likely than not" standard draw the right line between aggressive tax strategies and products that a registered public accounting firm ought not to plan, or opine on the tax treatment of, for an audit client and routine tax planning and advice? In addition, the Board invites comments on whether the Board also should require a registered public accounting firm to obtain a third-party tax opinion in support of the tax treatment, if the potential effect of the treatment could have a material effect on the audit client's financial statements.

4. Tax Services for Senior Officers in a Financial Reporting Oversight Role

Proposed Rule 3523 would provide that 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 tax service to an officer in a financial reporting oversight role at the audit client. This proposed rule would address concerns that performing tax services for certain individuals involved in the financial reporting processes of an issuer creates an appearance of a mutual interest between the auditor and those individuals.[72/]

Service." 26 C.F.R. § 1.6664-4(f)(2)(i)(B)(2). Proposed Rule 3522(c) would not permit registered public accounting firms, who themselves serve as tax advisors, to rely on other tax advisors to satisfy the rule's standard because registered firms that provide tax services are themselves in a position to perform such an analysis.

[72/] See Remarks of Mark Anson, Chief Investment Officer, California Public Employees' Retirement System, Roundtable Tr. at 146 ("When you have the audit firm

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Proposed Rule 3523 is narrowly tailored to include only those tax services that a registered public accounting firm provides to individuals in a position to play a significant role in an audit client's financial reporting. The proposed rule's use of the term "financial reporting oversight role" is based on the Commission's definition of "financial reporting oversight role," which includes any individual who has direct responsibility for oversight over those who prepare the issuer's financial statements and related information (e.g., management's discussion and analysis) that are included in filings with the Commission.[73/] Importantly, however, proposed Rule 3523 would apply only to tax services provided to officers in a financial reporting oversight role at an audit client; directors whose only role at an issuer audit client is to serve on the board would not be covered by the rule. Whether someone is an officer would depend on the person's function rather than title or designation in the company's bylaws.

The proposed rule does not distinguish between executive tax services paid for by the issuer and executive tax services paid directly by the officer. In either event, proposed Rule 3523 effectively would prohibit registered public accounting firms from providing personal tax services to officers in a financial reporting oversight role. The proposed rule, however, does not alter the existing requirement that a firm seek audit committee pre-approval to provide tax services paid for by the audit client to officers and

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providing tax advice, preparing tax returns for the senior management, you've now created a mutual interest between the executive management and that audit firm which could potentially taint the recommendation to that audit committee or the board of directors").

[73/] See Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Release No. 33-8183, § II.A (Jan. 28, 2003), 68 Fed. Reg. 6006, 6007 (Feb. 5, 2003), amended by 68 Fed. Reg. 15354 (Mar. 31, 2003). The Commission uses the term "financial reporting oversight role" to describe those executive positions that are covered by the Act's "cooling off" period, during which a public company would not be independent from its audit firm if a member of the engagement team for the audit of that company assumed such an executive position. See Sarbanes-Oxley Act, Section 206; 17 C.F.R. § 210.2-01(f)(3)(ii). The term "financial reporting oversight role" would be defined in proposed Rule 3501(f)(i). The proposed definition is verbatim the SEC's definition of the same term. See Rule 2-01 of the Commission's Regulation S-X, 17 C.F.R. § 210.2-01(f)(3)(ii).

other employees who do not meet the financial reporting oversight role criteria.[74/] While the accounting firm is not now required to seek pre-approval for executive tax services paid directly by the employee, the firm should consider under ISB Standard No. 1 whether it is necessary to notify the audit committee of these services.[75/]

The Board invites comments on any aspect of proposed Rule 3523 and encourages commenters to consider certain issues in particular. Are there other classes of employees to whom an accounting firm should not offer tax services? Would a registered public accounting firm's independence be perceived to be impaired if it offered tax services to members of an audit client's audit committee, or to other members of the audit client's board of directors?

C. The Auditor's Involvement with the Audit Committee

Under Section 10A(h) of the Exchange Act, as amended by Section 202 of the Sarbanes-Oxley Act, all non-audit services "shall be pre-approved by the audit committee of the issuer." The SEC's 2003 independence rules implemented the Act's pre-approval requirement by adopting a provision on audit committee administration of the engagement.[76/] Proposed Rule 3524 would implement the Act's pre-approval requirement further by strengthening the auditor's responsibilities in seeking audit committee pre-approval of tax services. Specifically, proposed Rule 3524 would require a registered public accounting firm that seeks pre-approval of an issuer audit client's

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[74/] The Board interprets existing Commission independence rules to require registered public accounting firms to seek audit committee pre-approval for executive tax services that are paid by the audit client. See 17 C.F.R. § 210.2-01(c)(7).

[75/] See ISB Standard No. 1; see also Taub Memo, supra note 22 at 5. The Board understands that some firms have adopted policies to notify the audit committee of all executive tax services provided to executives of the audit client, regardless of whether the services are required to be pre-approved. See, e.g., Remarks of Scott Bayless, Deloitte & Touche LLP, Roundtable Tr. at 152 (indicating that even when "the company does not pay for those services . . . there is a notification procedure to ensure that the audit committee has the ability to take control of that relationship if they so desire").

[76/] See 17 C.F.R. § 210.2-01(c)(7).

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audit committee to perform tax services that are not otherwise prohibited by the Act or the rules of the SEC or the Board to –

- Provide the audit committee detailed documentation of the nature and scope of the proposed tax service;
- Discuss with the audit committee the potential effects on the firm's independence that could be caused by the firm's performance of the proposed tax service; and
- Document the firm's discussion with the audit committee.

These proposed requirements are intended to buttress the pre-approval processes envisioned in the Commission's rules. Whether an audit committee pre-approves a non-audit service on an ad hoc basis or on the basis of policies and procedures, the Commission staff has stated that "detailed backup documentation that spells out the terms of each non-audit service to be provided by the auditor" should be provided to the audit committee.[77/] Proposed Rule 3524 would implement this requirement by requiring that registered firms provide audit committees of issuer audit clients an engagement letter that includes descriptions of the scope of any tax service under review and the fee structure for the engagement.[78/] The proposed rule also would require the auditor to provide to the audit committee any amendment to the engagement letter or any other agreement relating to the service (whether oral, written, or otherwise) between the firm and the audit client.[79/] While the Board does not expect or encourage auditors to enter into side agreements relating to tax services, the Board

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[77/] Taub Memo, supra note 22 at 3; see also SEC Office of the Chief Accountant: Application of the January 2003 Rules on Auditor Independence FAQs, Audit Committee Pre-approval, Answer No. 24, issued August 13, 2003 (available at www.sec.gov/info/accountants/ocafaqaudind080703.htm).

[78/] See Proposed Rule 3524(a)(i). Audit committees may ask auditors for other materials not identified in proposed Rule 3524, to assist them in their determinations whether to pre-approve proposed tax services. The proposed rule should not be understood to limit the information or materials that an audit committee may request, or that a registered firm may decide to provide, in connection with the pre-approval of tax services.

[79/] Id.

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understands that, in the past, some accounting firms have entered into such agreements.[80/] To the extent firms continue to do so, they must disclose those agreements to the audit committee.

In addition, to the extent that a registered public accounting firm receives fees or other consideration from a third party in connection with promoting, marketing or recommending a tax transaction, the proposed rule would require the firm to disclose those fees or other consideration to the audit committee. Specifically, proposed rule 3524(a)(ii) would require that the firm provide the audit committee "any compensation arrangement or other agreement, such as a referral agreement, a referral fee or fee-sharing arrangement, between the registered public accounting firm (or an affiliate of the firm) and any person (other than the audit client) with respect to the promoting, marketing or recommending of a transaction covered by the service." This proposed provision is adapted from the IRS's rules of practice, which require tax advisors to disclose such arrangements to taxpayer clients.[81/]

Proposed Rule 3524(b) also would require registered public accounting firms to discuss with audit committees of their issuer audit clients the potential effects of the proposed tax services on the firm's independence. Even if a non-audit service does not per se impair an auditor's independence, the Commission's independence rules nevertheless deem an auditor not to be independent 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.[82/]

[80/] See, e.g., In re PricewaterhouseCoopers LLP, & PricewaterhouseCoopers Securities LLC, AP 3-10835 (July 17, 2002) (noting that, "through side letters or oral understandings, the parties created contingent fee arrangements.").

[81/] See Internal Revenue Service Circular 230: Regulations Governing Practice Before the Internal Revenue Service, 31 C.F.R. Part 10.

[82/] 17 C.F.R. § 210.2-01(b).

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Like proposed Rule 3524(a), the intent of proposed Rule 3524(b) is to provide audit committees a robust foundation of information upon which to determine whether to pre-approve proposed tax services. While the Act "does not require the audit committee to make a particular finding in order to pre-approve an activity,"[83/] the Commission's rules require a robust review of proposed non-audit services –

> The audit committee must take its role seriously and perform diligent analyses and reviews that allow the committee to conclude that reasonable investors would view the auditor as capable of exercising objective and impartial judgment on all matters brought to the auditor's attention.[84/]

The proposed rule does not prescribe any test for audit committees or require audit committees to make legal assessments as to whether proposed services are prohibited or permissible, nor is it intended to limit an audit committee's discretion to establish its own more stringent pre-approval procedures. Rather, the proposed rule directs registered firms to present detailed information and analysis to audit committees for audit committees' consideration, in their own judgment, of the best interests of the issuer and its shareholders. The auditor's presentation may be informed by existing frameworks for evaluating independence, including the four principles that underlie the Commission's rules on auditor independence,[85/] but the proposed rule is designed not to

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[83/] S. REP. No. 107-205, at 19 (2002).

[84/] Taub Memo, supra note 22 at 7-8; see also SEC Office of the Chief Accountant: Application of the January 2003 Rules on Auditor Independence FAQs, Audit Committee Pre-approval, Answer No. 24, issued August 13, 2003 (available at www.sec.gov/info/accountants/ocafaqaudind080703.htm).

[85/] At least three participants in the roundtable discussion recommended that auditors use the principles set forth in the preliminary note to the SEC's Rule 2-01 as a foundation for evaluating whether pre-approval of a proposed tax service is advisable. See Remarks of Michael Gagnon, PricewaterhouseCoopers, Tr. 22-23 ("Whether it's compliance services, planning services, advisory-type tax services, I think it's very important to start with the framework of the principles. . . . [I]t is also important . . . that the context and facts and circumstances associated with the provision of tax services be considered and evaluated. . . . [I]t's important that audit committees are provided with information, full disclosure for the context, the facts and circumstances associated with

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drive a rigid, mechanical application of any such frameworks or principles. Instead, the proposed rule is intended to ensure that a registered firm provides an audit committee sufficient information to make its own informed judgments about the potential effects on the firm's independence of a tax service that is not already prohibited as a matter of law.

For instance, the Board envisions that, under proposed Rule 3524, a registered public accounting firm that sought pre-approval of tax compliance services, such as preparation of federal, state, local and other tax returns, would be required to provide the issuer's audit committee a copy of the proposed engagement letter, and any related agreements, to describe the scope of the proposed service and the proposed fee structure. That documentation should be sufficient to provide the audit committee the information contemplated by the Commission's rules –

> For example, a cover sheet may indicate that the audit committee is pre-approving the preparation of federal, state and local corporate tax returns. To comply with the rules regarding pre-approval, the backup documentation, however, must identify clearly each return and provide sufficient information for the audit committee to evaluate the impact of the filing of that return on the auditor's independence. This would require information on each jurisdiction where a return is filed, the type or types of tax (income, property, real estate, etc.) owed in each jurisdiction, how often each return is prepared and filed, and any other appropriate information.[86/]

In addition, through the discussion that would be required by proposed Rule 3524(b), the Board would expect registered firms to convey to the audit committee information sufficient to distinguish between tax services that could have a detrimental effect on the firm's independence – such as compliance services that, in effect, made up for the

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the provision of these services, as well as the framework of the principles so they can properly evaluate it."); Remarks of Bruce Webb, McGladrey & Pullen, Tr. 21 ("I agree that the overarching principles would apply to all services provided by the auditor. . . . It is my belief that issuer-specific transaction-based tax compliance and tax advisory services will generally fall within the overarching principles."); Remarks of James Brown, Crowe Chizek LLP, Tr. 29 ("[A]s a policy issue, we used these four [principles] in deciding, as our first step, what we could and couldn't do.").

[86/] Taub Memo, supra note 22 at 3.

absence of a competent internal tax department and risked placing the firm's personnel in the position of making decisions that should be made by management – and those that would be unlikely to have a detrimental effect – such as compliance services for a competent tax director who is capable of exercising sound judgment in the best interest of the company.[87/]

Proposed Rule 3524 is intentionally silent as to when a registered public accounting firm should provide the required information about a proposed tax service to an audit committee, because, under the SEC's 2003 independence rules, audit committees themselves may have policies that establish a procedure and schedule for audit committee review of non-audit services, including tax services.[88/] Similar to the SEC's 2003 independence rules, the Board's proposed Rule 3524 does not dictate, or even express a preference as to, whether the documentation and discussions required under proposed Rule 3524 should take place pursuant to an audit committee's policies and procedures on pre-approval or on an ad hoc basis. Many issuers have adopted policies that provide for pre-approval in annual audit committee meetings. The Board understands that such an annual planning process can include as robust a presentation to the audit committee as a case-by-case pre-approval process, and proposed Rule 3524 is designed to be flexible enough to accommodate either system and to encourage auditors and audit committees to develop systems tailored to the needs and attributes of the issuer.

Finally, proposed Rule 3524(c) would require a registered public accounting firm to document the substance of its discussion with the audit committee under subparagraph (b).

The Board welcomes comment on any aspect of proposed Rule 3524 and encourages comment on certain matters in particular. Should additional information or documentation that is not described in proposed Rule 3524 be provided to audit

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[87/] For example, PCAOB Rule 3600T, which adopted the AICPA Code of Professional Conduct, Interpretation No. 101-3, "Performance of Other Services," of ET § 101, *Independence*, as of April 16, 2003 states that "care should be taken not to perform management functions or make management decisions for attest clients the responsibility for which remains with the client's board of directors and management." (Interpretation No. 101-3 was amended by the AICPA in December 2003).

[88/] See 17 C.F.R. § 210.2-01(c)(7)(i)(B).

committees in the pre-approval process? In addition to the communications required by proposed Rule 3524, should auditors be required to have additional communications with the audit committee with regard to the tax advice that has been provided to the audit client?

IV. Effective Date

The Board proposes that the proposed rules become effective on the later of October 20, 2005, or 10 days after the date that the SEC approves the rules. That is, provided the following services did not impair a registered public accounting firm's independence under pre-existing SEC and PCAOB requirements, the Board will not treat a registered public accounting firm as not independent due to –

(a) tax services, in connection with a transaction described in proposed Rule 3522, that were completed by the registered public accounting firm no later than October 20, 2005, or 10 days after SEC approval of the rule, whichever is later; and

(b) tax services provided to audit client officers described in proposed Rule 3523 that were provided by the registered public accounting firm in connection with original returns filed no later than October 20, 2005, or 10 days after SEC approval of the rule, whichever is later.

The Board proposes October 20, 2005, as the effective date for these rules because it is shortly after the last date, applying all available extensions, that an individual taxpayer may file a personal federal tax return in connection with income earned in the preceding year (or, October 15). This effective date would permit officers in a financial reporting oversight role at audit clients to use the services of the registered public accounting firm that audits the audit client, or an affiliate of such a firm, in connection with those officers' 2004 federal income tax returns. For simplicity and in order to provide an appropriate transition period before the rules go into effect, the Board proposes to set the same effective date for the remaining rules in this proposal.

The Board notes that the Commission's Rule 2-01 on auditor independence treats an auditor as not independent if it enters into a contingent fee arrangement with an audit client today.[89/] The Board proposes that its proposed Rule 3521 will not apply to contingent fee arrangements that were paid in their entirety, converted to fixed fee

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89/ See 17 C.F.R. § 210.2-01(c)(5).

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arrangements, or otherwise unwound no later than October 20, 2005 or 10 days after SEC approval of the rule, whichever is later.

V. Opportunity for Public Comment

Interested persons are encouraged to submit their views to the Board. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments may also be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 017 in the subject or reference line and should be received by the Board no later than 5:00 p.m. (EST) on February 14, 2005.

* * *

On the 14th day of December, in the year 2004, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/

_____
J. Gordon Seymour
Acting Secretary

December 14, 2004

APPENDIX –

Proposed Rules on Tax Services

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Appendix – Rules

SECTION 3. PROFESSIONAL STANDARDS

Part 5 – Ethics

Rule 3501. Definitions of Terms Employed in Section 3, Part 5 of the Rules.

When used in Section 3, Part 5 of the Rules, unless the context otherwise requires:

(a)(i) Affiliate of the Accounting Firm

The term "affiliate of the accounting firm" (or "affiliate of the registered public accounting firm" or "affiliate of the firm") includes the accounting firm's parents; subsidiaries; pension, retirement, investment or similar plans; and any associated entities of the firm, as that term is used in Rule 2-01 of the Commission's Regulation S-X, 17 C.F.R. § 210.2-01(f)(2).

(a)(ii) Affiliate of the Audit Client

The term "affiliate of the audit client" means –

(1) An entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client's parents and subsidiaries;

(2) An entity over which the audit client has significant influence, unless the entity is not material to the audit client;

(3) An entity that has significant influence over the audit client, unless the audit client is not material to the entity; and

(4) Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex.

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(a)(iii) Audit and Professional Engagement Period

The term "audit and professional engagement period" includes both –

(1) The period covered by any financial statements being audited or reviewed (the "audit period"); and

(2) The period of the engagement to audit or review the audit client's financial statements or to prepare a report filed with the Commission (the "professional engagement period") –

(A) The professional engagement period begins when the registered public accounting firm either signs an initial engagement letter (or other agreement to review or audit a client's financial statements) or begins audit, review, or attest procedures, whichever is earlier; and

(B) The professional engagement period ends when the audit client or the registered public accounting firm notifies the Commission that the client is no longer that firm's audit client.

(3) For audits of the financial statements of foreign private issuers, the "audit and professional engagement period" does not include periods ended prior to the first day of the last fiscal year before the foreign private issuer first filed, or was required to file, a registration statement or report with the Commission, provided there has been full compliance with home country independence standards in all prior periods covered by any registration statement or report filed with the Commission.

(a)(iv) Audit Client

The term "audit client" means the entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of the audit client.

(c)(i) Contingent Fee

The term "contingent fee" means –

(1) Except as stated in paragraph (2) below, any fee established for the sale of a product or the performance of any service pursuant to an arrangement in

which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service.

(2) Solely for the purposes of this definition, a fee is not a "contingent fee" if the amount is fixed by courts or other public authorities and not dependent on a finding or result.

(f)(i) Financial Reporting Oversight Role

The term "financial reporting oversight role" means a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

(i)(i) Investment Company Complex

(1) The term "investment company complex" includes –

(i) An investment company and its investment adviser or sponsor;

(ii) Any entity controlled by or controlling an investment adviser or sponsor in paragraph (i) of this definition, or any entity under common control with an investment adviser or sponsor in paragraph (i) of this definition if the entity –

(A) Is an investment adviser or sponsor; or

(B) Is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company, investment adviser, or sponsor; and

(iii) Any investment company or entity that would be an investment company but for the exclusions provided by section 3(c) of the Investment

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Company Act of 1940 (15 U.S.C. § 80a-3(c)) that has an investment adviser or sponsor included in this definition by either paragraph (i) or (ii) of this definition.

(2) An investment adviser, for purposes of this definition, does not include a sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser.

(3) A sponsor, for purposes of this definition, is an entity that establishes a unit investment trust.

Rule 3502. Responsibility Not to Cause Violations.

A person associated with a registered public accounting firm shall not cause that registered public accounting firm to violate the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards, due to an act or omission the person knew or should have known would contribute to such violation.

Subpart 1 – Independence

Rule 3520. Auditor Independence.

A registered public accounting firm must be independent of its audit client throughout the audit and professional engagement period.

> Note: Under Rule 3520, a registered public accounting firm's independence obligation with respect to an audit client that is an issuer encompasses not only an obligation to satisfy the independence criteria set out in the rules and standards of the PCAOB, but also an obligation to satisfy all other independence criteria applicable to the engagement, including the independence criteria set out in the rules and regulations of the Commission under the federal securities laws.

Rule 3521. Contingent Fees.

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,

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provides any service or product to the audit client for a contingent fee or a commission, or receives from the audit client, directly or indirectly, a contingent fee or commission.

Rule 3522. Tax Transactions.

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 service to the audit client related to planning, or opining on the tax treatment of, a transaction –

(a) Listed Transactions – that is a listed transaction within the meaning of 26 C.F.R. § 6011.1-4(b)(2);

(b) Confidential Transactions – that is a confidential transaction within the meaning of 26 C.F.R. § 6011.1-4(b)(3), or that would be a confidential transaction within the meaning of 26 C.F.R. § 6011.1-4(b)(3) if the fee for the transaction were equal to or more than the minimum fee described in 26 C.F.R. § 6011.1-4(b)(3); or

(c) Aggressive Tax Positions – that was initially recommended by the registered public accounting firm or another tax advisor and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws.

Rule 3523. Tax Services for Senior Officers of Audit Client.

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 tax service to an officer in a financial reporting oversight role at the audit client.

Rule 3524. Audit Committee Pre-approval of Certain Tax Services.

In connection with seeking audit committee pre-approval to perform for an audit client any permissible tax service, a registered public accounting firm shall –

(a) provide to the audit committee of the audit client –

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(i) the engagement letter relating to the service, which shall include descriptions of the scope of the service and the fee structure, any amendment to the engagement letter, or any other agreement (whether oral, written, or otherwise) between the firm and the audit client, relating to the service; and

(ii) any compensation arrangement or other agreement, such as a referral agreement, a referral fee or fee-sharing arrangement, between the registered public accounting firm (or an affiliate of the firm) and any person (other than the audit client) with respect to the promoting, marketing, or recommending of a transaction covered by the service;

(b) discuss with the audit committee the potential effects of the services on the independence of the firm; and

(c) document the substance of its discussion with the audit committee.