



## RELEASE

Board

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### I. Introduction

On July 26, 2005, the Public Company Accounting Oversight Board ("PCAOB" or "Board") adopted certain rules related to registered public accounting firms' provision of tax services to public company audit clients. As part of this rulemaking, the Board adopted Rule 3523, which provides that a registered firm, subject to certain exceptions, is not independent of an audit client if the firm, or an affiliate of the firm, provides tax services during the audit and professional engagement period to a person in, or an immediate family member of a person in, a financial reporting oversight role at an audit client. This rule was intended to address concerns related to auditor independence when auditors provide personal tax services to individuals who play a direct role in preparing the financial statements of public company audit clients. Rule 3523 was approved by the Securities and Exchange Commission ("SEC" or "Commission") on April 19, 2006.

On April 3, 2007, the Board issued a concept release to solicit comment about the possible effects on a firm's independence of providing tax services to a person covered by Rule 3523 during the portion of the audit period that precedes the beginning of the professional engagement period and other practical consequences of applying the restrictions imposed by Rule 3523 to that portion of the audit period.<sup>1/</sup> The Board received 13 comment letters. Commenters included auditors, state certified public accountant societies, and one investor. The majority of the commenters recommended that the Board amend Rule 3523 to exclude the portion of the audit period that precedes the beginning of the professional engagement period.

After careful consideration of the comments received, the Board has decided to propose an amendment to Rule 3523 to exclude the portion of the audit period that precedes the beginning of the professional engagement period. However, as described below, in light of the comments received, the Board is also proposing a new independence rule that would require a registered public accounting firm to

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<sup>1/</sup> See PCAOB Release No. 2007-002 (April 3, 2007).

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communicate certain information as it relates to the firm's independence to the issuer's audit committee before accepting a new engagement pursuant to the standards of the PCAOB. The proposed rule would also require a registered public accounting firm to communicate certain information about its independence at least annually with respect to each of its issuer audit clients. The Board seeks comment on all aspects of these proposals.

Finally, on April 3, 2007, the Board also adjusted the implementation schedule for Rule 3523, as it applies to tax services provided during the period subject to audit but before the professional engagement period, so that the Board could revisit this aspect of the rule.<sup>2/</sup> As described below, the Board is further adjusting the implementation schedule to allow sufficient time for consideration of comments received in response to this release.

### **II. Proposed Amendment to Rule 3523 to Exclude the Portion of the Audit Period That Precedes the Professional Engagement Period**

Rule 3523 applies to registered firms in circumstances in which the firm, or an affiliate of the firm, provides or has provided tax services during the "audit and professional engagement period" to a person in, or an immediate family member of a person in, a financial reporting oversight role at an audit client. Consistent with the SEC's independence rules,<sup>3/</sup> the phrase "audit and professional engagement period" is defined to include two discrete periods of time. The "audit period" is the period covered by any financial statements being audited or reviewed.<sup>4/</sup> The "professional engagement period" is the period beginning when the firm either signs the initial engagement letter or begins audit procedures, whichever is earlier, and ends when either the company or the firm notifies the SEC that the company is no longer that firm's audit client.<sup>5/</sup>

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<sup>2/</sup> See PCAOB Release No. 2007-002 (April 3, 2007), at 7. Specifically, the Board stated that Rule 3523 will not apply to tax services provided on or before July 31, 2007, when those services are provided during the audit period and are completed before the professional engagement period begins.

<sup>3/</sup> 17 C.F.R. § 210.2-01(f)(5).

<sup>4/</sup> Rule 3501(a)(iii)(1).

<sup>5/</sup> Rule 3501(a)(iii)(2).

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In circumstances in which a registered firm has been the auditor for an audit client for more than a year, the "audit period" is a subset of the "professional engagement period." However, when a registered firm accepts a new audit client the audit period may cover a period of time before the commencement of the professional engagement period. In such circumstances, Rule 3523, as adopted, provides that the firm is not independent of its audit client if the firm, or an affiliate of the firm, provided tax services to a person covered by Rule 3523 during the audit period but before the professional engagement period. This aspect of the rule therefore effectively prevents a firm from accepting a new audit client when the firm, or an affiliate of the firm, provided tax services to such a person during the period covered by any financial statements to be audited or reviewed.

In preparing for implementation of the Board's tax services and independence rules, the Board decided to revisit the application of Rule 3523 to tax services provided during the audit period. On April 3, 2007, the Board issued a concept release to solicit comment about the possible effects on a firm's independence of providing tax services to a person covered by Rule 3523 during the portion of the audit period that precedes the beginning of the professional engagement period, and other practical consequences of applying the restrictions imposed by Rule 3523 to that portion of the audit period.

The Board received 13 comment letters on the concept release. Most commenters recommended amending Rule 3523 to exclude the portion of the audit period that precedes the professional engagement period. These commenters suggested that the accounting firm's independence would not be affected by the provision of tax services to a person in a financial reporting oversight role during the portion of the audit period that precedes the professional engagement period. Some of these commenters stated that a mutuality of interest does not exist during this time period because the accounting firm and the issuer do not have a professional audit client relationship at the time the tax services are provided to persons in financial reporting oversight roles.

All of these commenters also stated that if Rule 3523 is not amended to exclude the portion of the audit period that precedes the professional engagement period, it could adversely affect the company's ability to change auditors by limiting the company's choice of auditors. Commenters suggested that it is likely that persons in financial reporting oversight roles will use many different accounting firms for personal tax services and, therefore, finding an independent accounting firm to serve as a successor auditor could present a significant hardship for the issuer. According to one commenter, even when an issuer plans in advance to change auditors, Rule 3523, as

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currently adopted, could still create hardship for the issuer and the person in a financial reporting oversight role if the change is not planned sufficiently far in advance because many foreign tax compliance requirement dates for individuals do not follow the calendar-year cycle and also do not allow a mechanism for the extension of tax return filing deadlines.

Conversely, two of the commenters stated that Rule 3523 should not be amended to exclude the portion of the audit period that precedes the professional engagement period because they believe that providing tax services to a person in a financial reporting oversight role during the audit period impairs independence. These commenters also suggested that audit firms may plan for a change of auditors sufficiently in advance to avoid or minimize any problems resulting from the application of the rule to the audit period.

Additionally, a number of commenters recommended that even if the Board determines to exclude the portion of the audit period that precedes the professional engagement period from the scope of Rule 3523, the Board should allow a transition period for a new auditor to complete any tax services to persons in financial reporting oversight roles affected by the issuer's change of auditors in order to avoid any unnecessary hardship to such persons. Other commenters stated that tax services to persons in a financial reporting oversight role should cease before the professional engagement period begins.

After careful consideration, the Board is proposing an amendment to Rule 3523 to exclude the portion of the audit period that precedes the beginning of the professional engagement period. This would be accomplished by striking the words "audit and" from the current text of Rule 3523. The Board does not believe it is necessary to restrict the provision of tax services during the portion of the audit period that precedes the professional engagement period to preserve auditor independence. Unlike other SEC and PCAOB auditor independence rules that provide that firms are not independent if they or their affiliates have provided certain non-audit services to an audit client during the audit period,<sup>6/</sup> Rule 3523 relates to services provided to

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<sup>6/</sup> For example, SEC auditor independence rules state that an accountant is not independent if the accountant provides, among other things, bookkeeping, management functions, or financial information system design and implementation services to an audit client at any point during the audit and professional engagement period. 17 C.F.R. § 210.2-01(c)(4). In addition, PCAOB Rule 3522, *Tax Transactions*,

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individuals and not the audit client that issues the financial statements subject to audit. Additionally, if the Board amends Rule 3523 as described, registered firms would remain responsible for considering the relevant facts and circumstances of a specific tax engagement and determining whether their independence is impaired under the SEC's general standard of independence.<sup>7/</sup> The Board believes that this approach would allow for a more tailored application of the independence requirements to this area that would prohibit only those services that pose a risk, while allowing those that do not and avoid any unnecessary impediments to changing auditors.

In addition, in light of comments concerning the application of Rule 3523 in the context of an initial public offering, the Board is proposing to add a note to Rule 3523 that would state that in the context of an initial public offering, the provision of tax services to a person covered by Rule 3523 before the earlier of the date that the firm: (1) signed an initial engagement letter or other agreement to perform an audit pursuant to the standards of the PCAOB, or (2) began procedures to do so, does not impair a registered public accounting firm's independence under Rule 3523.

Finally, the Board considered comments requesting that the Board amend Rule 3523 to include a transition period to complete covered tax services once the professional engagement period begins. At this time the Board is not convinced that such a transition period is necessary. The Board is interested in receiving additional comment, however, on the practical implications of not allowing for a transition period.<sup>8/</sup>

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prohibits the auditor from providing certain non-audit services to an audit client during the audit period as well as the professional engagement period.

<sup>7/</sup> 17 C.F.R. § 210.2-01(b). The SEC's general standard on auditor independence treats an accountant as not 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. In determining whether any accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission."

<sup>8/</sup> The Board also considered comments requesting that the Board amend the rule to allow a transition period in various other circumstances, such as mergers and acquisitions, but has determined not to propose such amendments.

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### III. Proposed Rule 3526, Communication with Audit Committees Concerning Independence

Although the concept release did not seek comment regarding audit committee communication, several commenters encouraged the Board to consider requiring additional communication between the auditor and the issuer's audit committee about matters that might bear on the auditor's independence if the Board decided to amend Rule 3523. These commenters suggested that such additional communication would assist the audit committee in assessing the auditor's independence. One commenter encouraged the Board to require the accounting firm to discuss with the audit committee all tax services provided to a person in a financial reporting oversight role during the portion of the audit period that precedes the professional engagement period, as well as any such services to be provided during the professional engagement period pursuant to the recommended transition provisions. This commenter also stated that these services should be considered by the accounting firm in conjunction with its communication under *Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees* ("ISB No.1"), which requires the auditor to disclose all relationships between the auditor and its related entities and the company and its related entities that may reasonably be thought to bear on the auditor's independence.<sup>9/</sup> Another commenter stated that a determination of the impact of tax services to persons in a financial reporting oversight role should be left exclusively to the audit committee.

Under Section 301 of the Sarbanes-Oxley Act of 2002 ("the Act"), "[t]he audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer...for the purpose of preparing or issuing an audit report or related work."<sup>10/</sup> The Act, along with the SEC's related implementation rules, enhanced the required communication between the audit

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<sup>9/</sup> *Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees*. ISB No. 1 is included in the Board's interim standards.

<sup>10/</sup> The SEC has implemented this provision by adopting rules directing the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by the Act.

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committee and the auditor by requiring the issuer's audit committee to pre-approve audit and non-audit services provided by the auditor.<sup>11/</sup> However, the accounting firm does not have an existing requirement under SEC or PCAOB rules to provide information to the audit committee about the auditor's independence, including whether services are being provided to the issuer or any person in a financial reporting oversight role, in connection with *becoming* the issuer's auditor (i.e., *before* the person or firm becomes the issuer's auditor). While the ISB No. 1 communication is important, it typically occurs at the end of the audit when the financial statements are issued. As a result, it is not sufficient to ensure that appropriate information concerning the auditor's independence is communicated to the issuer's audit committee at the time that the audit committee is making the decision to retain the accounting firm as the issuer's auditor.

The Board believes that the accounting firm should discuss with the audit committee before accepting an initial engagement pursuant to the standards of the PCAOB any services the accounting firm has provided or is providing that may reasonably be thought to bear on independence. A requirement to communicate such information would provide the audit committee with information that may be important to its determination about whether to hire the firm as the company's auditor. Accordingly, the Board is proposing a new independence rule, Rule 3526, *Communication with Audit Committees Concerning Independence*.

The current requirement under ISB No. 1 requires the auditor to disclose to the audit committee, among other things, 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. Proposed Rule 3526 would build on that communication and require the registered public accounting firm, *prior to accepting an initial engagement* pursuant to the standards of the PCAOB, to –

1. describe, in writing, to the audit committee<sup>12/</sup> of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm

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<sup>11/</sup> See Section 202 of the Act; 17 C.F.R. § 210.2-01(c)(7).

<sup>12/</sup> Under Section 2(a)(3) of the Act, "[t]he term 'audit committee' means – (A) a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and (B) if no

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and the potential audit client or persons in a financial reporting oversight role at the potential audit client that may reasonably be thought to bear on independence;

2. discuss with the audit committee of the issuer the potential effects of these relationships on the independence of the registered public accounting firm, should it be appointed the issuer's auditor; and
3. document the substance of its discussion with the audit committee of the issuer.

The registered public accounting firm would also be required on at least an annual basis after becoming the issuer's auditor to –

1. describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the audit client or persons in a financial reporting oversight role at the audit client that may reasonably be thought to bear on independence;
2. discuss with the audit committee of the issuer the potential effects of these relationships on the independence of the registered public accounting firm;
3. affirm to the audit committee of the issuer, in writing, that the registered public accounting firm is independent in compliance with Rule 3520; and
4. document the substance of its discussion with the audit committee of the issuer.

The proposed rule would require disclosure of all relationships that may reasonably be thought to bear on independence whether those relationships existed during the period under audit or during earlier periods. In determining what relationships may reasonably be thought to bear on independence, the accounting firm would need to consider, in addition to whether the firm provided any specifically prohibited services or maintained any specifically prohibited relationships, the SEC's general standard on

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such committee exists with respect to an issuer, the entire board of directors of the issuer." Accordingly, under the proposed rule, if an audit client does not have an audit committee, the auditor would be required to make the communications to the entire board of directors.

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auditor independence. Under that standard, an accountant is not 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."<sup>13/</sup> In considering this general standard, the SEC "looks in the first instance to whether a relationship or the provision of 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."<sup>14/</sup>

Auditors would also need to consider AU sec. 220, *Independence*, in determining whether a particular relationship needs to be discussed with the audit committee. AU sec. 220 requires that "in all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor." AU sec. 220 notes that "[i]t is of utmost importance that the general public maintain confidence in the independence of independent auditors," and that public confidence in the auditor's independence "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."

The proposed rule would require only those relationships that "may reasonably be thought to bear on independence" to be disclosed to the audit committee. This language is taken from ISB No. 1, and is consistent with the SEC's general standard on independence, which focuses on the perception of the "reasonable investor," and AU sec. 220, which focuses on the perceptions of "reasonable people." Unlike ISB No. 1, however, the proposed rule would not modify this basic reasonableness standard with the words "in the auditor's professional judgment." The Board believes that omitting these words will clarify the requirement by reminding auditors of the need to focus on the perceptions of reasonable third parties when making independence determinations. Auditors will, of course, need to apply professional judgment to determine what is reasonable under particular facts and circumstances.

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<sup>13/</sup> 17 C.F.R. § 210.2-01(b).

<sup>14/</sup> 17 C.F.R. § 210.2-01, preliminary note.

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In addition, the proposed rule would describe the existing ISB No. 1 requirement to "discuss the auditor's independence with the audit committee" with more specificity. Specifically, the proposed rule would require the auditor to discuss with the audit committee of the issuer the potential effects of the relationships on the independence of the accounting firm. This articulation is intended to emphasize that the required communication should provide the audit committee with sufficient information to understand how a particular relationship might affect independence and to foster a robust discussion. The proposed rule would also add a new requirement for the firm to document the substance of its discussion with the audit committee.

Finally, if proposed Rule 3526 is adopted, it would supersede ISB No. 1 and two related interpretations – ISB Interpretation 00-1, *The Applicability of ISB Standard No. 1 When "Secondary Auditors" Are Involved in the Audit of a Registrant*, and ISB Interpretation 00-2, *The Applicability of ISB Standard No. 1 When "Secondary Auditors" Are Involved in the Audit of a Registrant, An Amendment of Interpretation 00-1*. The interpretations state that the responsibility to comply with ISB No. 1 rests with the primary auditor, but that the primary auditor should include in its report to the audit committee all relationships of its domestic and foreign associated firms that could reasonably bear on the independence of the primary auditor. Under these interpretations, if the primary auditor is relying on the work of secondary auditors not associated with the primary auditor's firm, the report of the primary auditor should either describe any such secondary auditors' relationships, or it should state that it does not do so. The proposed rule's treatment of secondary auditors would be similar to the treatment of secondary auditors under ISB No. 1 and the two interpretations. Specifically, secondary auditors would not need to comply with proposed Rule 3526, but the primary auditor would need to disclose to the audit committee any relationships of the firm's affiliates. Proposed Rule 3526 would not establish requirements relating to secondary auditors working on an audit that are not affiliated with the auditor of record.

The Board solicits comment on all aspects of these proposals, and in particular –

1. Would proposed Rule 3526 assist registered firms and audit committees in fulfilling their respective obligations with respect to auditor independence?
2. Would proposed Rule 3526 assist audit committees in making a decision regarding the appointment of a new auditor?
3. Should proposed Rule 3526 require the registered public accounting firm to communicate any additional matters on auditor independence to the

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audit committee? If so, what specific communications should the auditor be required to make to the audit committee?

4. To what extent if any, are accounting firms already making the kinds of communications that would be required by proposed Rule 3526?
5. Should the initial communication required under proposed Rule 3526(a) be limited to relationships that existed during a particular period? If so, why, and how long should the period be?
6. Should the Board provide a transition period in Rule 3523 to allow a registered public accounting firm to complete covered tax services once the professional engagement period begins? If so, why is such a transition period necessary? How long should any such transition period be?

## IV. Opportunity for Public Comment

The Board will seek comment for a 45-day period. Interested persons are encouraged to submit their views to the Board. Written comments should be sent to Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's Web site at [www.pcaobus.org](http://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 PM (EST) on September 7, 2007.

The Board will carefully consider all comments received. Following the close of the comment period, the Board will determine whether to amend Rule 3523 and adopt a final rule on communication with audit committees concerning independence. Any rule amendment and final rule adopted will be submitted to the Securities and Exchange Commission for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission.

## V. Adjustment of Implementation Schedule

Under the adjustment to the implementation schedule for Rule 3523 that the Board made on April 3, 2007, the Board will not apply Rule 3523 to tax services provided on or before July 31, 2007, when those services are provided during the audit period and are completed before the professional engagement period begins. The Board has determined to further adjust the implementation schedule for Rule 3523 to

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allow sufficient time for consideration of comments on this release. Specifically, the Board will not apply Rule 3523 to tax services provided on or before April 30, 2008, when those services are provided during the audit period and are completed before the professional engagement period begins.<sup>15/</sup>

The PCAOB has filed this adjustment to the implementation schedule with the SEC as an immediately effective proposed rule change. The rule change became effective upon its filing with the SEC, thereby extending to April 30, 2008 the implementation date for this aspect of Rule 3523. The adjustment to the implementation schedule and related rule filing will not result in any textual changes to the Rules of the PCAOB.

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On the 24 day of July, in the year 2007, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

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J. Gordon Seymour  
Secretary

July 24, 2007

<sup>15/</sup> This will apply regardless of whether there is an engagement in process on July 31, 2007.

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APPENDIX 1 – Proposed Amendment to Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*

APPENDIX 2 – Proposed Ethics and Independence Rule 3526, *Communication with Audit Committees Concerning Independence*

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**Appendix 1 – Proposed Amendment to Rule 3523**

The relevant portion of the Rule, as amended, is set out below. Language deleted by this amendment is struck through. Language that is added is underlined>.

**RULES OF THE BOARD**

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**SECTION 3. PROFESSIONAL STANDARDS**

\* \* \*

**Part 5 – Ethics**

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**Subpart I – Independence**

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**Rule 3523. Tax Services for Persons in Financial Reporting Oversight Roles**

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 a person in a financial reporting oversight role at the audit client, or an immediate family member of such person, unless –

(a) the person is in a financial reporting oversight role at the audit client only because he or she serves as a member of the board of directors or similar management or governing body of the audit client;

(b) the person is in a financial reporting oversight role at the audit client only because of the person's relationship to an affiliate of the entity being audited –

(1) whose financial statements are not material to the consolidated financial statements of the entity being audited; or

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(2) whose financial statements are audited by an auditor other than the firm or an associated person of the firm; or

(c) the person was not in a financial reporting oversight role at the audit client before a hiring, promotion, or other change in employment event and the tax services are –

(1) provided pursuant to an engagement in process before the hiring, promotion, or other change in employment event; and

(2) completed on or before 180 days after the hiring or promotion event.

Note: In the context of an initial public offering, the provision of tax services to a person covered by Rule 3523 before the earlier of the date that the firm: (1) signed an initial engagement letter or other agreement to perform an audit pursuant to the standards of the PCAOB, or (2) began procedures to do so, does not impair a registered public accounting firm's independence under Rule 3523.

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**Appendix 2 – Proposed Ethics and Independence Rule 3526, Communication with Audit Committees Concerning Independence**

**RULES OF THE BOARD**

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**SECTION 3. PROFESSIONAL STANDARDS**

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**Part 5 – Ethics**

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**Subpart I – Independence**

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**Proposed Rule 3526. Communication with Audit Committees Concerning Independence**

A registered public accounting firm must –

(a) prior to accepting an initial engagement pursuant to the standards of the PCAOB –

(1) describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in a financial reporting oversight role at the potential audit client that may reasonably be thought to bear on independence;

(2) discuss with the audit committee of the issuer the potential effects of the relationships described in subsection (a)(1) on the independence of the registered public accounting firm, should it be appointed the issuer's auditor; and

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

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(b) at least annually with respect to each of its issuer audit clients –

(1) describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the audit client or persons in a financial reporting oversight role at the audit client that may reasonably be thought to bear on independence;

(2) discuss with the audit committee of the issuer the potential effects of the relationships described in subsection (b)(1) on the independence of the registered public accounting firm;

(3) affirm to the audit committee of the issuer, in writing, that the registered public accounting firm is independent in compliance with Rule 3520; and

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