

An Update for Audit Committees: New Rules on Auditor Provided Tax Services

By Catherine Allen

In 2004, concerns about two types of tax services led the Public Company Accounting Oversight Board (PCAOB) to conduct a comprehensive review of auditors' provision of tax services to their public company audit clients. The first concern involved abusive tax shelter transactions that some auditors were promoting to their clients either directly or in concert with other parties. The second concern involved auditors providing tax services to executives of their public company audit clients, including tax shelter products. Multiple government investigations, including a U.S. Senate hearing and legal actions by the U.S. Department of Justice, ignited serious concerns about these—and possibly other—tax services and their effect on auditor independence.

The fledgling PCAOB gave the issue prompt attention and subsequently adopted (among other independence and ethics rules) new rules governing these two specific types of tax services and an enhanced protocol for audit committee pre-approval applying to *all* tax services. In April 2006, the Securities and Exchange Commission (SEC) approved the PCAOB's rules. This article discusses the new PCAOB tax-related independence rules, and particularly, PCAOB and SEC expectations for audit committee pre-approval of tax services.

Tax Transactions

Rule 3522, *Tax Transactions*, addresses the auditor's involvement with confidential or aggressive tax transactions. Under this rule,

independence is impaired if the auditor provided services to an audit client involving marketing, planning, or opining *in favor of* a confidential transaction or an aggressive tax position. The PCAOB believes that opining in favor of such a transaction causes the auditor and the client to have inappropriate joint interests in the results of the transaction, especially given the high likelihood that a tax authority will question and possibly disallow the transaction. Independence is not affected if the auditor's services involve opining *against* a confidential or aggressive tax position, as this situation does not align the auditor's and client's interests.

These tax services are problematic when they occur during the period of the professional engagement—a period that starts when an auditor is initially engaged—or during the “audit period”—the time frame of the financial statements (or other information) being audited. This rule became effective on June 18, 2006.

Persons in Financial Reporting Oversight Roles

Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*, states that independence is impaired if an accounting firm provides tax services to a person who is in a “financial reporting oversight role” with an audit client, or to the person's spouse or dependents. This rule also applies during the audit and professional engagement periods, although the PCAOB has recently issued a concept release with regard to how the rule applies to newly engaged auditors. The PCAOB believes that providing tax services to persons responsible for the client's financial reporting creates the appearance of mutual interests between the auditor and the company's financial managers.

Certain exceptions were built into the rule; for example, non-executive board members, and entities controlled by persons in financial reporting oversight roles are generally not subject to the rule. Although tax services may not be provided to persons in financial reporting oversight roles, auditors may continue to provide

Director Summary: The author discusses the new PCAOB auditor independence rules related to tax services. She particularly emphasizes the PCAOB and SEC expectations for audit committee pre-approval of tax services, noting that audit committee members should be prepared to make an educated decision based on a full understanding of the manner in which the tax services will be provided.



In discharging their duties, members should not hesitate to ask the auditors questions to attain a full and clear understanding of the manner in which the services would be provided.

other services (such as financial planning) to these persons. Nevertheless, the PCAOB recommended that auditors consider whether they should inform their clients' audit committees of such situations to ensure that the "reasonable investor" perspective is considered. In April 2007 the PCAOB solicited comments on one aspect of rule 3523. The issue the PCAOB sought to address was the difficulty some companies were having changing auditors due to the retroactive application of the rule. To allow the PCAOB to consider the comments and determine whether or not to amend the rule, it extended the transition period of this portion of rule 3523 to July 31, 2007. Thus, until this date, the rule does not apply to tax services provided during the audit period to financial management of a company if the services are completed before the professional engagement period begins, i.e., generally before appointment of the new audit firm.

Audit Committee Pre-Approval

Rule 3524, *Audit Committee Pre-Approval of Certain Tax Services*, raises the bar that auditors must meet to enable audit committee pre-approval of proposed tax services. As before, audit committees have significant flexibility in the way they pre-approve services—format and timing are not prescribed. Thus, audit committees may continue to pre-approve services on either an ad hoc basis or in accordance with the committee's established protocol. Under this rule, auditors seeking pre-approval of tax services must follow a three-step process:

- Provide the audit committee a written, detailed description of the nature and scope of the proposed tax services, related fee, and other arrangements;
- Discuss the proposal and the potential impact of the service and related matters on independence with the audit committee; and
- Document the substance of the discussion.

If an audit committee pre-approves services on an ad hoc basis, the rule became effective on June 18, 2006. If an audit committee pre-approves services on the basis of policies and procedures, the rule became effective on

April 20, 2007. The PCAOB will likely adopt a similar rule for internal control-related services in 2007.

SEC and PCAOB Expectations

The SEC and PCAOB expect audit committees and auditors to engage in robust discussions regarding proposed tax services and their potential impact on the auditor's independence. Auditors should provide audit committees enough detail about the proposed services, fee arrangements, and related agreements—as well as analysis about how these might affect independence—to foster a meaningful discussion about independence in the eyes of the reasonable investor.

As a proxy for the reasonable investor, the audit committee should judge whether, in light of all relevant facts and circumstances, they believe that independence is impaired. The committee is not required to make a legalistic assessment of whether a particular service should be permitted. Rather, the four basic principles of independence (SEC Regulation S-X, Rule 2-01, *Qualifications of Accountants*) should guide the audit committee and be at the forefront of any discussions regarding independence. They are:

- (1) The auditor should not function in the role of management.
- (2) The auditor should not audit his or her own work.
- (3) The auditor should not serve in an advocacy role for his or her client.
- (4) The auditor should not have a mutual or conflicting interest with the client.

To apply these principles properly, audit committee members need to understand how the engagement will be performed and especially, the respective activities that the audit firm and client management plan to undertake. In discharging their duties, members should not hesitate to ask the auditors questions to attain a full and clear understanding of the manner in which the services would be provided.

The PCAOB adopted rule 3524 to enhance the quality and depth of the information that auditors provide audit committees to help them make informed decisions about proposed tax services. Armed with this information, the audit committee should be prepared to make an educated decision about the proposed tax services, any related matters, and the potential impact of these on auditor independence. ■

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