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## **BRIEFING PAPER**

### **BOARD CONSIDERS ETHICS AND INDEPENDENCE RULES CONCERNING INDEPENDENCE, TAX SERVICES, AND CONTINGENT FEES**

**JULY 26, 2005 PUBLIC MEETING OF THE BOARD**

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At its meeting today, the Public Company Accounting Oversight Board will consider the adoption of certain ethics and independence rules addressing tax services, contingent fees, and certain related general ethics and independence standards.

Section 103(a) of the Sarbanes-Oxley Act of 2002 directs the Board to establish "ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports." Moreover, Section 103(b) of the Act directs the Board to establish 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."

Since the enactment of the Act and the issuance in 2003 of new independence rules by the Securities and Exchange Commission, two types of tax services have raised serious questions 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 and the Department of Justice have brought a number of cases against accounting firms in connection with those firms' marketing of potentially abusive tax shelter products and, specifically, those firms' alleged failures to register, or comply with list maintenance requirements relating to, their tax shelter products. Second, audit firms have been criticized for providing tax services, including tax shelter products, to senior executives of public company audit clients. Some have questioned whether an auditor's provision of such services could lead to conflicts of interest.

Over the last year, 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 in July 2004. On December 14, 2004, the Board proposed, for public

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comment, certain independence and ethics rules addressing contingent fees, aggressive tax transactions, and tax services provided to persons in financial reporting oversight roles at the audit client. The Board received 805 comment letters from investors, auditors, regulators, and others showing generally wide support for the proposal.

The ethics and independence rules being considered today for adoption fall into three areas. First, the rules identify three circumstances in which the provision of tax services impairs an auditor's independence –

- Rule 3521 would treat registered public accounting firms as not independent of their audit clients if they enter into contingent fee arrangements with those clients.
- Rule 3522(a) would treat a registered public accounting firm as not independent from an audit client if the firm provides services related to marketing, planning, or opining in favor of the tax treatment of a transaction that is a confidential transaction as defined in Rule 3501. In addition, Rule 3522(b) would treat a registered public accounting firm as not independent if the firm provides services related to marketing, planning, or opining in favor of a tax treatment on a transaction that is based on an aggressive interpretation of applicable tax laws and regulations. Rule 3522(b)'s scope would also include listed transactions as defined by U.S. Treasury Department regulations.
- Rule 3523 will treat a registered public accounting firm as not independent if the firm provides tax services to certain members of management who serve in financial reporting oversight roles at an audit client or to immediate family members of such persons.

Second, the rules further implement the Act's pre-approval requirement by strengthening the auditor's responsibilities in connection with seeking audit committee pre-approval of tax services. Specifically, Rule 3524 would require a registered public accounting firm that seeks such pre-approval to describe proposed tax services engagements, in writing, for the audit committee; to discuss with the audit committee the potential effects of the services on the firm's independence; and to document the substance of that discussion.

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Third, the rules under consideration today would lay a foundation for the Board's independence rules. Specifically, Rule 3502 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 professional standards due to an act or omission that the person knew, or was reckless in not knowing, would directly and substantially contribute to such violation. Rule 3520 would include a general obligation requiring a registered public accounting firm and its associated persons to be independent of the firm's audit clients throughout the audit and professional engagement period.

Finally, the Board is considering several definitions in Rule 3501 that are integral to the operation of the rules being considered.

These rules, if adopted today, will not take effect unless approved by the Securities and Exchange Commission pursuant to Section 107(b) of the Sarbanes-Oxley Act. The Board's release would explain transition periods applicable to each rule that is adopted. Background information on these rules is available on the Board's Web site at [www.pcaobus.org](http://www.pcaobus.org) under Rulemaking.

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