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Tax Services and Auditor Independence

Rules proposed by the Public Company Accounting Oversight Board would limit the tax services independent auditors can offer their public-company audit clients and affect the way audit committees fulfill their responsibilities under the Sarbanes-Oxley Act and SEC auditor independence rules.¹ The proposed rules would ban all contingent-fee arrangements and make some tax services incompatible with auditor independence, including all tax services provided to officers “in a financial reporting oversight role.” The proposal would also expand pre-approval procedures by requiring auditors to supply audit committees with specified information about permitted tax services that might be performed and to discuss the information with the committee.

Some Tax Services Incompatible with Auditor Independence

An auditor’s independence would be impaired under the proposal by providing planning advice or a tax opinion on an “aggressive” tax position or on a “listed transaction” or a “confidential transaction” as defined by Treasury regulations. A tax position is aggressive under the proposal if it has the following characteristics:

- It was originally recommended by the auditor or another tax advisor,
- Tax avoidance is a significant purpose of the transaction, and
- The position is “more likely than not” to be *disallowable* under the tax law.

Auditor independence would also be impaired by providing tax services to officers “in a financial reporting oversight role.” A “financial reporting oversight role,” according to the proposal, permits a person to influence the contents of the financial statements or anyone who prepares them. Persons would be assumed to have that influence if they perform the following functions: the chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, or treasurer.

¹ PCAOB Release No. 2004-015, Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees, December 14, 2004, Rulemaking Docket Matter No. 017, available at www.pcaobus.org. SEC Release No. 33-8183, Strengthening the Commission’s Requirements Regarding Auditor Independence, January 28, 2003, available at www.sec.gov.



The SEC's definition of a "financial reporting oversight role" includes members of the board of directors. According to the PCAOB's proposal, an auditor's independence would not be impaired by providing tax services to board members unless they functioned in one of the roles just cited.

Contingent Fees

Auditor independence would be impaired under the proposed rules by contingent-fee arrangements for any service, whether the contingent element of the fee is a direct or indirect feature of the arrangement. A fee is contingent if the right to collect it or the size of the fee to be charged depends on a specified finding or result. Auditor independence would also be impaired under the proposed rules by commission-fee arrangements.

Tax Services Compatible with Auditor Independence

The PCAOB release acknowledges that a number of tax services have not raised what it calls "independence concerns" and would continue to be permitted—subject to audit committee pre-approval. Among those cited in the release are tax return preparation and tax compliance services, general tax planning and advice (including related tax research), tax return preparation for employees on international assignments, and personal tax services for client employees who are not in a financial reporting oversight role.

These services must be pre-approved by the audit committee, just as all other services to be provided by the independent auditor must by law be pre-approved. However, the proposed rules would require the auditor to give the audit committee a detailed description of the nature and scope of each proposed tax service, then discuss with the committee the potential effects of performing the services on the firm's independence, and finally, document the substance of the discussion. The information submitted to the audit committee would have to include a separate engagement letter for each service that sets out its scope and the fee arrangement.



The PCAOB will consider comments on its proposal and then adopt a rule for submission to the SEC, whose review and approval are necessary before the rule is final. Under the proposal, the rules would become effective on the later of October 20, 2005 or 10 days after the SEC's approval. Comments to the PCAOB are due by February 14, 2005.

Companies should not treat the descriptive and summary statements above about the proposed rule as if they are what the PCAOB will adopt or what the SEC will subsequently approve. They should consult the final PCAOB rule as approved by the SEC and their accounting and legal advisors.

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