TAX SERVICES UNDER THE SARBANES-OXLEY ACT

Several provisions to the Sarbanes-Oxley Act will make it difficult for accountants to continue performing some tax services. This is the first of a two-part article.

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On February 6, 2003, the Securities and Exchange Commission (SEC) issued final regulations interpreting those provisions of the Sarbanes-Oxley Act of 2002 that relate to the services performed by CPA firms for their SEC-registered audit clients. To the relief of many, the regulations do not *specifically* prohibit the performance of most tax services. A number of provisions, however, will make it difficult to continue performing some tax services. In this article, the new regulations and their impact on accounting firms, on management, and on corporate audit committees will be examined. The limitations on the scope of services and on audit partner compensation, and the requirement that audit committees pre-approve all tax services will be analyzed.

To perform an audit, an accountant must be independent. For auditors of SEC-registered companies, the federal regulations include detailed rules governing the determination of auditor independence.[1] Severe sanctions can be levied against auditors found to lack independence. An audit client can suffer as well. For example, where an auditor is found to lack independence a re-audit may be ordered.

This article, which is in two parts, covers three sections of the new auditor independence rules that have an impact on tax services. These are: Scope of services limitations, audit committee approvals of non-audit services, and limitations on audit partner compensation.

Scope-of-services limitations: The new regulations prohibit accounting firms from performing nine non-audit services. A number of these services are often performed in conjunction with tax services. By prohibiting these services, the regulations prohibit part of tax services engagements. For accounting firms, this means loss of important work. For management, this means that, where outside auditors are used for tax work, a portion of a tax project may need to be performed by a firm unrelated to the outside auditors.

Audit committee approvals of non-audit services: Under Sarbanes-Oxley and the new SEC regulations, corporate audit committees of SEC-registered companies must pre-approve audit and non-audit services, including tax services, when the services are provided by outside auditors. For the auditors, this means that not only must they pitch tax services to management, they must obtain separate approval from the audit committee. For management, this means a loss of decision-making power to the audit committee. For audit committees, the new rule means heavy new responsibilities, without much guidance. The rules also require a level of involvement in company management that may not be practical. The new rules may

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cause auditors to lose lucrative tax work. They may also force management to purchase tax services from firms that are unaffiliated with the auditors, resulting in costlier, but less effective, tax advice.

Audit partner compensation: To perform an audit, an accounting firm needs extensive knowledge of a company, and the trust of its management. Knowledge and trust also give auditors an edge when selling non-audit services to their clients, especially if the audit partner heads up the sales team. An audit partner can be an effective seller of non-audit services, and an enthusiastic salesperson if he or she is paid for sales made. However, the SEC believes that compensating an audit partner for selling non-audit services creates a conflict that compromises that person's independence and objectivity. To prevent this conflict, the SEC has adopted rules prohibiting an audit partner from receiving such compensation. Whether this new rule will improve the quality of audits is not known. What is certain, however, is that the rule will make it more difficult for accounting firms to sell tax and other non-audit services to their audit clients.

The scope of services rules will be discussed in Part 1 of this article, with the remaining topics discussed in Part 2, which will be published in the September/October issue of *Corporate Finance Review*.

Scope of services limitations

Section 201 of Sarbanes-Oxley prohibits auditors from performing for their audit clients non-audit services that compromise independence. The new law names nine services that are specifically prohibited. Accountants may continue to perform any non-audit service that is not otherwise prohibited, including tax services, which is approved in advance by the client's audit committee.[2]

These rules apply only to audits of companies subject to SEC registration. In addition, the new rules do not prohibit an accountant from providing these services for a non-audit client. The SEC has adopted final regulations interpreting Section 201. The new regulations replace existing regulations, adopted in November 2000,[3] which prohibited most of these services, but which contained many exceptions.

The nine prohibited services in Sarbanes-Oxley were written based on three principles, violation of any one of which is deemed to impair independence and render an accountant incapable of auditing a client's financial statements. These principles are: "(1) An auditor cannot function in the role of management, (2) an auditor cannot audit his or her own work, and (3) an auditor cannot serve in an advocacy role for his or her client."[4]

Some commentators have asserted that Sarbanes-Oxley gives corporate audit committees broad discretion to approve almost any tax service. They point to language in the Release accompanying the SEC proposed regulations that support this position. In addition, commentators asked the SEC to make clear that any tax service can be performed for an audit client without impairing independence. However, the SEC declined to make such a broad statement. As discussed in the following sections, the SEC continues to believe that the performance of some tax services can impair independence. In addition, non-tax services performed in connection with a tax engagement cannot be performed without impairing independence, if they fall within one of the nine prohibited services.

CIRCUMSTANCES THAT *COULD* IMPAIR INDEPENDENCE ARE LEFT, FOR THE MOST PART, UNSTATED.

Six of the nine prohibited services can have an impact on the provision of tax services, and will be covered here. These are:

- Bookkeeping or other services-related accounting records;
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- Actuarial services;
- Management functions;
- Legal services; and
- Expert services.

SEC guidance on tax services. In the Release accompanying its new regulations, the SEC provides guidance on permitted tax services. However, the guidance is general, and leaves much to the judgment of audit committees. The SEC reiterated its "long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence." Reasons it gives for permitting such services are: (1) "Detailed tax laws must be consistently applied, and the Internal Revenue Service has discretion to audit any tax return." (2) "[A]ccounting firms have historically provided a broad range of tax services to their audit clients." (3) Sarbanes-Oxley "recognized that accountants may engage in certain non-audit services 'including tax services'."[5]

According to the Release, "accountants may continue to provide tax services such as tax compliance, tax planning, and tax advice to audit

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clients, subject to the normal audit committee pre-approval requirements."[6] "Tax compliance generally involves preparation of original and amended tax returns, claims for refund and tax payment-planning services. Tax planning and tax advice encompass a diverse range of services, including assistance with tax audits and appeals, tax advice related to mergers and acquisitions, employee benefit plans and requests for rulings or technical advice from taxing authorities."[7]

The SEC rules are consistent with Sarbanes-Oxley, which says, "A registered public accounting firm may engage in any non-audit service, including tax services, that is not [one of the nine prohibited services], for an audit client, only if the activity is approved in advance by the audit committee of the issuer."[8]

Some conclude from the portions of the regulations cited previously that virtually any kind of tax service is permissible. However, this is not the case. Some, but not all, tax services can be performed by the auditors, and the criteria for audit committee approval of such services is whether or not performance of tax services compromises auditor independence.

In its Release, the SEC counsels audit committees and accountants that "providing certain tax services to an audit client would, as described below, or could, in certain circumstances, impair the independence of the accountant."[9] The SEC Release states that "[a]ccountants *would* impair their independence by representing an audit client before any court of law."[10]

Circumstances that *could* impair independence are left, for the most part, unstated. The SEC provides only one example where there is possible impairment of independence: "[A]udit committees also should scrutinize carefully the retention of an accountant 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."[11]

Therefore, the SEC is leaving it up to audit committees to make determinations regarding the allowance of most tax services. Unfortunately, the SEC provides scant guidance to audit committees for determining whether a tax service does or does not impair independence, and the history surrounding both Sarbanes-Oxley and the new regulations is ambiguous. The SEC does not say whether audit committees should use the three principals mentioned previously in approving tax services.[12] Some who have commented on the regulations, in their proposed form, asserted that these principals should not be applied to tax services. The rationale for this argument is (1) the performance of many tax services would violate the three principals, if they are applied as written, (2) however, Sarbanes-Oxley and the SEC regulations confirm that tax services can be performed for audit clients, (3) therefore, these principals should not be applied to tax services.[13] However, the SEC, in its Release, declined to say whether these three tests should be applied.

THE FINANCIAL STATEMENTS OF A CORPORATION ARE THE RESPONSIBILITY OF COMPANY MANAGEMENT.

Although the regulations are not clear on this point, I believe that audit committees should consider the three principles stated above when approving tax services.

For example, XYZ, Inc. hires Jones LLP to audit its financial statements, to prepare its tax returns, and to provide tax advice. In March 2004, Jones LLP's tax professionals formulate for the company a tax strategy that materially reduces the company's tax liability. In January 2005, the auditors must evaluate the company's tax provision, opining on the tax results of the strategy. This places the accountants in the position of auditing their firm's own tax work. In this case, the audit committee has no assurance that the auditors will remain unbiased when they audit the tax provision. The SEC regulations do not appear to prohibit the auditors from performing these services, and independence may not be *legally* impaired. However, is independence impaired *in fact?* This is the audit committee's judgment call.

In a situation where there is a possibility of impairment, the audit committee can remedy the situation by ordering a separate review of the company's tax provision by an accounting firm or law firm. There are situations, however, where a second opinion is not practical.

For example, Jones LLP develops a proprietary tax strategy, which it markets to its audit clients. This is a pre-packaged tax planning device that is tailored to the needs of specific clients. The fee for the strategy is not based on the number of hours spent implementing the plan, but is instead based on the tax saved using the strategy. This tax "product" is marketed under a nondisclosure agreement.[14] Accordingly, the client cannot bring in another tax advisor to independently evaluate the strategy.

Differentiating between tax and non-tax services. The audit committee has broad discretion to approve tax services. However, the committee cannot approve any of the nine prohibited ser-

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vices. Often, prohibited services are performed in conjunction with tax services. Where this is the case, prohibited services must be identified and carved out of the tax services engagement. Differentiation between tax and non-tax services will, in some cases, be difficult, and will call for careful analysis by audit committees.

THE NEW RESTRICTIONS MAY AFFECT THE ABILITY OF A FIRM TO PROVIDE TAX SERVICES RELATED TO RETIREMENT PLANS.

The SEC provides two examples where labeling of services was the issue. "[A]n accountant seeking to provide a broker-dealer service and arguing that, because there are tax implications of certain brokerage activities, the service is permissible would constitute an attempt to improperly circumvent the list of prohibited services."[15] On the other hand, an audit committee can receive permission from the SEC for the approval of a service labeled a "legal service" in a foreign jurisdiction, where the same service is an allowable tax service in the United States.[16]

Bookkeeping or other services related to accounting records. The financial statements of a corporation are the responsibility of company management. An auditor's responsibility is limited to examining those statements. Because an auditor should not be placed in the position of auditing its own work, the regulations prohibit an accountant from performing bookkeeping and financial statement preparation for its SEC-registered audit clients. In the context of tax services, this prohibition can include preparation of a company's tax accrual, and possibly its tax returns.

The new regulations include a rebuttable presumption that bookkeeping and related services performed for an audit client will be subject to audit procedures.[17] Therefore, if an auditor performs such services, which may include, for example, preparing source data to support numbers to be incorporated in the financial statements, then the auditor must demonstrate that the services will not be subject to audit procedures by the auditor. This rule can preclude preparation of a corporate tax provision that will be incorporated in the company's financial statements, or preparation of the company's tax returns.

For example, Jones LLP is an accounting firm engaged to audit the financial statements of XYZ, Inc., an SEC-registered company. XYZ lacks expertise to prepare its own tax returns and asks Jones LLP to prepare them. In addition, it asks Jones LLP to calculate the tax expense that will be reported in the financial statements. If Jones LLP performs these services, it may well be placed in a position of calculating amounts that will be included in the financial statements, and will be later subject to audit. The question is: Are these services prohibited?

Despite the appearance of conflict created when an accounting firm performs the tax services described in this example, the SEC, in its Release, opines that accountants can provide tax services without impairing independence (see previous discussion). Therefore, the preparation of a tax return should not, according to the SEC Release, impair independence. In addition, professional standards say that an accountant's independence is not impaired by proposing adjusting entries or other changes affecting the financial statements.[18] Therefore, an auditor could prepare a tax accrual calculation, and propose an adjusting entry to the client.

Appraisal or valuation services, fairness opinions, or contribution-in-kind reports. Under the SEC regulations an accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides "[a]ny appraisal service, valuation service, or any service involving a fairness opinion or contribution-in-kind report for an audit client, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements."[19]

The SEC describes these services as follows:

- Appraisal and valuation services include "any process of valuing assets, both tangible and intangible, or liabilities. They include valuing, among other things, in-process research and development, financial instruments, assets and liabilities acquired in a merger, and real estate."
- "Fairness opinions and contribution-in-kind reports are opinions and reports in which the firm provides its opinion on the adequacy of consideration in a transaction."[20]

The new rules are the same, in most respects, as the old SEC regulations. However, the old rules contained four specific exceptions, while the new regulations contain only one general exception. Two of the old exceptions are arguably covered by the one exception in the new regulations. These are: (1) an auditor's valuation expert can review the work of a client's specialist, and (2) valuations can be performed for non-financial purposes, where the valuations do not affect the financial statements. The remaining two exceptions under the old regulations are probably not covered by the exception in the new regulations. Under the old regulations: (3) an auditor's actuaries could value a client's pension or other post-

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retirement benefit obligation provided that the client assumes responsibility for significant assumptions, and (4) valuations were allowed when performed for planning and implementing tax-planning strategies.[21]

The first two exceptions appear to be covered by the single exception in the new regulations, which says that services can be performed if it is "reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements." Under this single exception an auditor's valuation expert can, for example, review the work of a client's specialist as part of an audit engagement. In its Release on the new rules, the SEC says, "the rule does not prohibit an accounting firm from utilizing its own valuation specialist to review the work performed by the audit client itself or an independent, third-party specialist employed by the audit client, provided the audit client or the client's specialist (and not the specialist used by the accounting firm) provides the technical expertise that the client uses in determining the required amounts recorded in the client financial statements. In those instances, the accountant will not be auditing his or her own work because a third party or the audit client is the source of the financial information subject to the audit. Additionally, the quality of the audit may be improved where specialists are utilized in such situations."[22]

For example, XYZ, Inc. distributes to its shareholders the stock of its wholly owned subsidiary, M Corporation. There is no public market for the stock of M Corporation. The distribution results in taxable income to XYZ, and therefore the stock must be valued. XYZ employs a company specializing in the appraisal of the stock of closely held corporations. Jones LLP later audits the financial statements of XYZ. Because the tax effect of the distribution is material to the income of XYZ, Jones LLP must audit the transaction. Jones LLP can use its own valuation experts to review the work of the appraisal company, and will not thereby violate the new regulations.

The second of the previous exceptions applied if an accountant was never placed in the position of auditing its own appraisal. This exception continues to apply.

Under the old rules, accountants could value a client's pension liability. However, this service is now prohibited if the liability is later included in the company's financial statements, and is subject to audit. The old rules contained an exception for valuations associated with the planning and implementation of tax strategies. This was a broad exception that left room for a substantial number of services. The SEC's Release accompanying the new regulations states that the new rules "do not prohibit an accounting firm from providing such services for non-financial reporting (e.g., transfer-pricing studies, cost-segregation studies, and other tax-only valuations) purposes."[23] However, such services will be allowed only where the results of the work will not be subject to audit. Any work that materially affects the financial statements will be prohibited.

AUDITORS ARE NOT INDEPENDENT IF THEY PERFORM MANAGEMENT FUNCTIONS.

For example, XYZ, Inc. transfers assets to a newly formed Irish subsidiary in a transaction that is taxable under Section 367. The tax liability, which is material to the financial statements, must be determined based on a valuation of the assets transferred. Since the results of the valuation will be subject to later audit, the auditors cannot provide the valuation services.

In another example, XYZ, Inc. enters into a qualified cost-sharing arrangement with its Irish subsidiary, under which the companies will jointly conduct a research project to develop a new technology. The Irish company will own the non-U.S. rights to the technology and XYZ will own the U.S. rights. Under this arrangement, research costs must be allocated to the two companies based on the income each anticipates earning from exploitation of the technology. These earnings must be calculated by forecasting both sales and costs. The allocation of research cost has a material tax effect. Accordingly, the auditors are prohibited from preparing the forecasts.

Actuarial services. Under the new regulations, an auditor lacks independence if it performs for a public company "[a]ny actuarially oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts for the audit client other than assisting a client in understanding the methods, models, assumptions, and inputs used in computing an amount, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements."[24]

The new rules represent a broad prohibition, whereas the previous rules applied only to actuarial services related to insurance company policy reserves and related accounts.[25]

The new restrictions may affect the ability of a firm to provide tax services related to retirement plans. The accountants can continue to provide tax planning services in this area, but are prohibited

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from performing actuarial computations if the results materially affect the company's financial statements. For example, the firm would be prohibited from calculating the client's unfunded liability under a defined benefit pension plan.

The new regulations allow, however, an auditor to use its own actuaries to test an amount already calculated by the client. Such testing may be a necessary part of an audit.

Management functions. Auditors are not independent if they perform management functions, which include "acting temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client."[26] In regard to tax services, there is a question as to whether auditors effectively make decisions on behalf of clients when they provide tax planning services, the validity of which the client has no way to determine. In these cases, the client relies solely on the auditor.

Legal services. An auditor lacks independence when it engages in "[p]roviding any service to an audit client that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided."[27]

This prohibition carries over the SEC's previous rule without substantial change. The basis of the prohibition is the assumption that a lawyer's core professional obligation is to be an advocate for its clients' interests, and that "an individual cannot be both a zealous legal advocate for management or the client company, and maintain the objectivity and impartiality that are necessary for an audit."[28] In its Release, the SEC quoted the U.S. Supreme Court in *United States v. Arthur Young:* "If investors were to view the accountant as an advocate for the corporate client, the value of the audit function itself might well be lost."[29]

Accounting firms in the United States do not ordinarily represent clients in court, so this restriction should not be a burden.[30] For non-U.S. accounting firms that are subject to these regulations, the new rules present a problem. According to the SEC Release, "in some jurisdictions it is mandatory that someone licensed to practice law perform tax work, and that an accounting firm providing such services, therefore, would be deemed to be providing legal services." On its face, the rule would prohibit one of these foreign accounting firms from performing tax services. However, the SEC goes on in its Release to say, "our rules are not intended to prohibit foreign accounting firms from providing services that an accounting firm in the United States may provide. In determining whether or not a service would impair the accountant's independence solely because the service is labeled a legal service in a foreign jurisdiction, the Commission will consider whether the provision of the service would be prohibited in the United States as well as in the foreign jurisdiction ....Evaluating and determining whether services are permissible may require a comprehensive analysis of the facts and circumstances. We are, however, sensitive to these issues and, as we have done in the past, we encourage accounting firms and foreign regulators to consult with the staff to address these issues."[31]

It appears from this that the accounting firms to which the SEC refers must immediately initiate discussions with the SEC to determine what services will be considered "prohibited legal services."

THE RULE IS PROHIBITING AN ACCOUNTANT FROM PROVIDING CERTAIN TAX SERVICES TO AUDIT CLIENTS AND ITS APPLICATION IN CONNECTION WITH AN SEC INVESTIGATION.

Expert services. The new SEC regulations say that an accountant will not be independent if he or she provides "an expert opinion or other expert service for an audit client, or an audit client's legal representative, for the purpose of advocating an audit client's interests in litigation or in a regulatory or administrative proceeding or investigation. In any litigation or regulatory or administrative proceeding or investigation, an accountant's independence shall not be deemed to be impaired if the accountant provides factual accounts, including in testimony, of work performed or explains the positions taken or conclusions reached during the performance of any service provided by the accountant for the audit client."[32]

This prohibition is not found in the previous SEC regulations. Its addition to the list of prohibited services is required by Sarbanes-Oxley. Sarbanes-Oxley, while prohibiting accounting firms from performing expert services for their audit clients, did not define the term. In writing its regulations, the SEC interpreted the term based on its analysis of the legislative history of the new law. According to the SEC, "the legislative history related to expert services is focused on the accountant's role when serving in an advocacy capacity."[33] Therefore, just as an accounting firm is not independent if it acts as a client's legal advocate, it cannot be independent if it advocates a client's position in other ways. To understand this rule, it is useful to explore its various components.

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Expert opinion. "Expert opinion" is not defined in the regulations, however according to the SEC Release, "[c]lients retain experts to lend authority to their contentions in various proceedings by virtue of the expert's specialized knowledge and experience." Therefore, we must conclude that an expert opinion is any communication, written or not, that expresses an opinion incorporating the firm's specialized knowledge and experience. It could include, for example, a letter sent by an auditor to the IRS that argues in support of a tax position taken by its client.

Definition of expert service. The provision of an expert service refers to "engagements that are intended to result in the accounting firm's specialized knowledge, experience and expertise being used to support the audit client's positions in various adversarial proceedings." According to the SEC, "virtually all services provided by an accountant may be perceived to be expert services." Therefore, the term does not describe a specific kind of service, such as litigation support services, but instead refers to services performed to advocate a client's position in official proceedings.

Advocating an audit client's interest. The key to understanding this prohibition is to realize that, under the new regulations, auditors cannot be seen to advocate on behalf of their clients. According to the SEC, the prohibition on expert services "applies to those services that involve advocacy in proceedings and investigations." The SEC further says, "The appearance of advocacy created by providing such expert services is sufficient to deem the accountant's independence impaired." An accountant can be considered to be working in an advocacy capacity "even if the accountant is working behind the scenes to advance the client's interests."[34]

For example, XYZ, Inc. is under investigation by the SEC's Division of Enforcement, and wants to hire its auditor, Jones LLP, to provide forensic accounting services to the company's legal representatives in connection with its defense in this proceeding. If Jones LLP provides these services, its independence will be impaired because it is providing expert services in support of its client's position in an advocacy capacity.

Litigation or regulatory or administrative proceedings or investigations. Tax-related proceedings covered by this rule appear to include, for example, litigation in any court and audits by the IRS or state and local tax authorities. Some who commented on the regulations when proposed believed that the rules should prohibit only public advocacy or public adversarial proceedings.[35] However, this is not the direction the final rules take. For example, the rules prohibit an accountant from providing forensic services to a client's attorney in connection with an SEC investigation.[36]

Permitted expert services. The auditors can render expert services so long as they do not act as the client's advocate. The SEC provides examples of permitted activities:[37]

- Auditors can be engaged by the client audit committee, or at its direction, by its legal counsel, to perform internal investigations or fact-finding engagements. "These types of engagements may include, among others, forensic or other fact-finding work that results in the issuance of a report to the audit client."
- Auditors can be engaged to assist an audit committee "in fulfilling its responsibilities to conduct its own investigation of a potential accounting impropriety." On the other hand, independence is impaired if "its assistance to the audit committee included defending, or helping to defend, the audit committee or the company generally in a shareholder class action or derivative lawsuit, other than as a fact witness."
- If the auditors discover fraud during a permitted engagement, and litigation or investigation commences while they are still engaged, the auditors can complete the engagement. However, continuance of the engagement is permitted only so long as "the auditor remains in control of his or her work and that work does not become subject to the direction or influence of legal counsel for the [client]."
- In an investigation or proceeding, an auditor can provide factual accounts or testimony regarding work performed. Independence is not impaired where, for example, "an accountant explains the positions taken or conclusions reached during the performance of any service provided by the accountant for the audit client."

ANY NEW RULES ADOPTED BY THE PCAOB ARE SUBJECT TO APPROVAL BY THE SEC

Impact of expert service prohibition on tax services. Most tax services performed for an audit client would not be prohibited under the expert services rule, since the auditor does not ordinarily act as an advocate for the company in official proceedings. Tax services that would not be prohibited under this rule include tax planning and consulting, and tax return preparation. Representation of a company in a controversy with tax authorities, or in court, are the kinds of services that potentially violate this rule.

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Representation of an audit client in an IRS examination appears to meet the three criteria for a violation of this rule: (1) expert services, (2) advocating a client position, (3) in a regulatory proceeding. According to the SEC, the auditor can participate in a proceeding, but its services are limited to explaining its work or the positions taken. Therefore, it appears that a company cannot hire its auditor to take a lead position in representing it in a dispute with the IRS. It must hire for this purpose another accounting firm or a law firm. The auditor can participate in the proceedings, but its role is limited to explaining what it has done in the past. The auditor may not participate, even behind the scenes, in formulating new positions or devising strategies in defense of its client.

For example, in 2003, Jones LLP provides tax planning services to XYZ, Inc., its audit client, the result of which is the formation of Foreign Co., an Irish corporation, which sells XYZ products to customers in the European Union. In 2004, XYZ is audited by the IRS. XYZ is a public company, and Jones LLP may not be able to act as its representative before the IRS because it would be providing expert services, advocating the company's position, in an administrative investigation. Instead, another accounting firm, Smith LLP, is hired to represent the company. Jones LLP is engaged by the company to meet with Smith LLP and with the IRS to explain its 2003 tax planning, and to explain the preparation of 2003 tax returns. However, it must provide these services in a way that limits its role to providing facts. It cannot participate with the company or with Smith LLP in formulating new positions or in preparing strategies to defend the company.

THERE IS NO INDICATION AS TO THE POSITION THE PCAOB WILL TAKE ON TAX SERVICES.

Although the ban on expert services appears to prohibit an auditor from taking the lead in representing an audit client in an IRS examination, this conclusion is not free from doubt. Some commentators have found support in the SEC Release for an opposite conclusion. As discussed previously, the SEC acknowledges that tax services can be performed, with the approval of the audit committee, without impairing independence. In addition, the statements in the Release imply that assistance with tax audits and appeals does not impair independence.[38] From these two statements, at least one commentator has concluded that representation before the IRS in a tax audit or appeal is not a prohibited expert service.[39] However, the SEC does not say whether this conclusion is correct, despite the fact that the commentator asked it to do so.

In my opinion, an auditor is probably prohibited from taking the lead position in a controversy with tax authorities but acknowledges that a contrary opinion may be supported. This is an area where additional guidance is needed.

Legislative assistance. One tax service not mentioned in the new regulations is legislative assistance (lobbying.) Some commentators assert that services performed in conjunction with tax legislation are traditional tax services, which should be allowed under the new rules. However, there is a fear that such services may be prohibited as expert services, since the accountant could be seen as advocating a client's position. Clearly, if the accountant renders an expert service, the service may be seen as advocating a client's position, and, the forum may be seen as regulatory or administrative. Therefore, the danger that this service is prohibited is real. Despite many requests for guidance, the SEC failed to mention legislative assistance services in its regulations. Until such guidance is issued, the application of the prohibition against expert services to this kind of activity is not clear.

Audit and professional engagement period. The services described above are prohibited during the *audit and professional engagement period.* This period includes:

- The period *covered* by any financial statements being audited or reviewed, and
- The period of the *engagement* to audit or review the financial statements. The engagement period begins on the earlier of signing an engagement letter or beginning the audit or review work. It ends when the SEC is notified that the client is no longer an audit client. (Special rules exist for audits of non-U.S. companies.)[40]

PCAOB-initiated prohibitions. Sarbanes-Oxley provides that the Public Company Accounting Oversight Board (PCAOB) can prohibit "any other service that the Board determines, by regulation, is impermissible."[41] This means that, although the SEC chose not to place heavy restrictions on the performance of tax services, the PCAOB can still do so. There is no indication as to the position the PCAOB will take on tax services. We do know, however, that they will look at this area, since some members have publicly stated that the Board will examine the issue of tax services, and its effect on an auditor's independence. Any new rules adopted by the PCAOB are subject to approval by the SEC. Therefore, if the SEC is not convinced of the efficacy of a rule that, for example, bans a CPA from performing certain tax services, then it can refuse to approve the rule.

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Charles Niemeier, acting chairman of the PCAOB, told London's *Financial Times* that the PCAOB may look at whether tax work threatens auditor independence.[42] Niemeier did not indicate how the PCAOB might rule on the question, but mentioned the problems associated with Sprint, where company auditors advised top executives on how to eliminate current tax on hundreds of millions in stock option profits. The tax shelters used to accomplish this are now under attack by the IRS.

Daniel Goelzer of the PCAOB is quoted as saying, "auditors should not be in the position of marketing tax shelters to their audit clients."[43]

Douglas Carmichael, the PCAOB's chief auditor, has been critical of auditors that are heavy sellers of non-audit services. Therefore, when it comes to a question of whether a tax service is prohibited, the bias may be toward disallowance. According to Carmichael, in testimony before the SEC, critics of limitations on consulting services "have stated that there is no evidence that a single audit has been compromised by the audit firm having performed consulting services for the client." Carmichael says that this kind of statement is not true, and goes on in his testimony to cite a number of instances where, in his opinion, auditor independence was impaired by the presence of consulting services. In his testimony, he disagrees with the theory that consulting services improves audits.[44] It is likely Carmichael's contentions will never be proved or disproved. Neither will the contentions of those who support continued consulting services for audit clients. It is important, however, that Carmichael, an avowed critic of current practices in accounting firms, is in a position to enforce his point of view. It is significant that the PCAOB selected Carmichael for this important position, given his views, and it is an indication that the PCAOB intends to shake things up.

Effective dates of SEC regulations

The effective date of these regulations is May 6, 2003. However, the provision of otherwise impermissible services will not impair independence until May 6, 2004 if those services are pursuant to contracts in existence on May 6, 2003, unless those services impaired independence under the SEC's old regulations. In addition, the Office of the Chief Accountant of the SEC, or the Public Company Accounting Oversight Board, can extend the effective date.[45]

The second half of this article will be presented in the September/October issue of Corporate Finance Review. ■

NOTES

1 17 CFR Sec. 210.2-01.
2 Securities Exchange Act, § 10A(h).
3 See SEC Release No. 33-7919 (Nov. 21, 2000).
4 SEC Release No. 33-8183 (Feb. 6, 2003), § II.B.
5 SEC Release No. 33-8183, § II.B.11.
6 See note 5 *supra.*
7 SEC Release No. 33-8183, at § II.H.
8 See note 2 *supra.*
9 See note 5 *supra.*
10 See note 5 *supra.*
11 See note 5 *supra.*
12 See note 4 *supra.*
13 See, e.g., letter from Ernst & Young, to SEC, dated January 6, available on SEC Web site.
14 See complaint in *Camferdam v. Ernst & Young*, Dist. Ct. NY, reported in 2002 TNT 248-4 (Dec. 26, 2002), wherein it is alleged that, "Before revealing any aspect of the COBRA strategy to the Individual Plaintiffs, Ernst & Young and Hoeing required them to agree to pay Ernst & Young a non-refundable fee totaling $1,056,000 and to sign a nondisclosure agreement forbidding them from disclosing the strategy to any person."
15 See note 5 *supra*, at note 111.
16 SEC Release No. 33-8183, at § II.B.9.
17 SEC Release No. 33-8183, at § II.B.1. note 52.
18 AICPA Professional Standards, ET § 101.05.
19 See note 1 *supra*, at (c)(4)(iii).
20 SEC Release No. 33-8183, at § II.B.3.
21 See note 4 *supra*, at Note 57 for a listing of the prior exceptions.
22 SEC Release No. 33-8183, at § II.B.3.
23 See note 22 *supra.*
24 See note 1 *supra*, at (c)(4)(iv).
25 SEC Release No. 33-8183, at § II.B.4.
26 See note 1 *supra*, at (c)(4)(vi).
27 See note 1 *supra*, at (c)(4)(ix).
28 See note 16 *supra.*
29 *United States v. Arthur Young*, 465 U.S. 805 (1984), note 15.
30 However, accountants are also prohibited from providing expert services to their public company audit clients, which may have the effect of preventing them from representing their clients in any forum.
31 See note 16 *supra.*
32 See note 1 *supra*, at (c)(4)(x).
33 SEC Release No. 33-8183, at § II.B.10.
34 See note 33 *supra.*
35 See, e.g., letter to SEC from PricewaterhouseCoopers (Jan. 8, 2003).
36 See note 33 *supra.*
37 See note 33 *supra.*
38 See note 7 *supra.*
39 See, e.g., letter to SEC from PricewaterhouseCoopers (Dec. 26, 2002). Available on SEC Web site.
40 See note 1 *supra*, at (c)(4).
41 See note 2 *supra*, at (g)(9).
42 A. Parker and A. Michaels, "US Accounts Watchdog Threatens Tax Crackdown," *Financial Times* (Apr. 16, 2003).
43 "Senate OKs Tougher SEC Power; Accounting Groups Assist Practitioners," *TNT* (Apr. 14, 2003): 72-77.
44 Douglas Carmichael, Securities and Exchange Commission Hearings on Release No. 33-7872 (July 26, 2000).
45 See note 1 *supra*, at (e)(1).

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