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SEC Approves PCAOB Rules on Auditor Independence

The SEC approved PCAOB rules on auditor independence that affect how public-company audit committees fulfill their responsibilities under the Sarbanes-Oxley Act and SEC regulations.¹ The new rules limit the types of tax services independent auditors may provide to their SEC audit clients, prohibit tax services to specified individuals associated with an audit client, and expand auditors' communications to audit committees about permitted tax services. The PCAOB rules also prohibit all commission- and contingent-fee arrangements with SEC audit clients, arrangements already prohibited by the SEC. The requirements have varying effective dates, but some are effective immediately.

Tax Services

The new rules identify types of tax services that are inconsistent with independence from an SEC audit client. An audit firm is not independent if it provides any services to the client pertaining to "marketing, planning, or opining in favor of" tax transactions that are performed under a confidentiality condition or that are "aggressive," as the rule defines the term.

For purposes of the rule, a transaction is confidential if a tax advisor "places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies." This definition includes situations in which the auditor provides tax services under a confidentiality condition that is imposed by a third-party tax advisor.

Tax transactions are aggressive if they meet all of the following criteria: (1) the transaction is initially recommended by the audit firm, either directly or indirectly; (2) a significant purpose of the transaction is tax avoidance; and (3) the tax treatment is not at least "more likely than not" to be allowable under applicable federal, state, local, or foreign tax laws. Transactions that are "listed" by the Internal Revenue Service are "aggressive" according to the rules. "Tax avoidance" includes acceleration of deductions or deferrals of taxable income. We understand that the term "tax transaction" is meant to be interpreted broadly under the new rules.

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¹ PCAOB, Releases No. 2005-014, *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, July 26, 2005; No. 2005-020 *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, November 22, 2005; and No. 2006-001 *Implementation Schedule for Certain Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, March 28, 2006. SEC Release No. 34-53677, *Public Company Accounting Oversight Board; Order Approving Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees and Notice of Filing and Order Granting Accelerated Approval of the Amendment Delaying Implementation of Certain of these Rules*, April 19, 2006.



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An audit firm is also not independent of an SEC audit client if it provides any tax services to a person who serves in a “financial reporting oversight role” at that client or at one of its material affiliates. The rules apply this provision not only to the individual serving in the role, but also to any immediate family member of a person serving in that role. The characteristic that identifies a “financial reporting oversight role” is the ability to exercise influence over the contents of the financial statements or anyone who prepares them. The following roles are among those that meet the criterion: chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, and director of internal controls compliance. Tax services to a Board member are permitted provided the Board member does not also function in any of the other financial reporting oversight roles.

Audit Committee Pre-Approval of Permitted Tax Services

Auditors may continue to provide to their SEC audit clients all tax services that are not expressly limited or prohibited by the independence rules, if the services are pre-approved by the audit committee. Audit committees may continue to pre-approve tax services provided by the auditor according to their stated policies and procedures.

The new PCAOB rules require the auditor to provide the audit committee with a written description of the nature and scope of the tax-services engagement, including the fee arrangements, to discuss with the audit committee the potential effects of the services on the audit firm’s independence, and to document the discussion in the audit work papers. We believe some audit committees may consider these pre-approval requirements for tax services to be equally useful in fulfilling their responsibilities for pre-approving other non-audit services.

Implementation Guidance

The SEC requested that the PCAOB provide additional implementation guidance for the approved rules in the following areas:

- Independence considerations when a transaction the auditor initially recommended is subsequently “listed” by the Internal Revenue Service,
- Use of the term “planning” as it relates to tax transactions,
- The scope of the rule’s confidentiality restrictions, and
- Tax service engagements involving persons in financial reporting oversight roles at material affiliates.

The timing and content of the guidance has not been determined.

Effective Dates

The new rules are effective as of June 18, 2006, except in the following circumstances:

- New tax engagements for persons in a “financial reporting oversight role” at an SEC audit client are prohibited effective April 19, 2006. Engagements for such persons that are in-process at April 19, 2006 may continue, but must be completed by October 31, 2006.
- The rules for discussions with audit committees that pre-approve services pursuant to policies and procedures and for documenting those discussions do not apply to any tax service that is begun before April 20, 2007.

The descriptive and summary statements above about the final PCAOB rules are not a substitute for the texts of those rules. Entities that must comply with related SEC requirements should consult the texts of the applicable documents and consult their accounting and legal advisors.