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Tax Litigation Issues

BY JOHN J. TIGUE JR. AND JEREMY H. TEMKIN

Further Restrictions on the Role of Auditors of Public Companies

Major executives of public companies soon may find themselves in need of new accountants to handle their personal tax services.

The Securities and Exchange Commission's (SEC) recent adoption of rules issued by the Public Company Accountant Oversight Board (PCAOB) prohibiting auditors of public companies from performing personal tax services for certain executives will likely result in significant shuffling of the client lists of many accounting firms in the coming months.

Put simply, individuals in financial oversight roles at public companies (including the CEOs and CFOs) can no longer afford themselves of tax advice from the company's outside accounting firm without compromising the auditor's independence. Hence, there is sure to be a lot of maneuvering by accounting firms and executives alike to avoid such conflicts.

The changes set forth in the new rule are significant as auditors commonly have provided tax preparation and planning services to both public companies and the executives of those companies. Now, certain members of the senior management of public companies will be required to engage tax service professionals unaffiliated with the accounting firm that serves as the corporate auditor of record. As the PCAOB has acknowledged, the new rule likely will impact the revenue of accounting firms, requiring them to terminate existing engagements. Losses attributable to the prohibition of nonauditing services once performed by accounting firms will now be compounded by the inability to provide tax services to corporate executives.

Creation and Purpose of PCAOB

Before the Sarbanes-Oxley Act of 2002, the accounting profession had been almost free from government regulation. During the hearings leading up to Sarbanes-Oxley, Congress concluded that the self-regulatory efforts of the accounting profession and the SEC's system of accounting oversight were ineffective and in need of a major overhaul necessitating government intervention.[1] Thus, the act set forth a regulatory scheme directed at the accounting profession and created the PCAOB to act as overseer of the scheme and hence the "watchdog" of the accounting profession.[2]

John J. Tigue Jr. *is a principal in Morvillo, Abramowitz, Grand, Iason & Silberberg and a fellow of the American College of Trial Lawyers.* **Jeremy H. Temkin** *also is a principal in Morvillo, Abramowitz.* **Gretchan R. Ohlig,** *an attorney, assisted in the preparation of this article.*

John J. Tigue Jr. *Jeremy H. Temkin*

According to its Web site, "[t]he PCAOB is a private-sector, nonprofit 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."[3] In this capacity, the PCAOB serves to regulate accountant behavior, thus removing a significant level of autonomy that accountants enjoyed before the act. The PCAOB has the authority to promulgate rules and regulations, govern accountant conduct, carry out investigations, and institute disciplinary and enforcement actions.[4] The PCAOB also is charged with creating auditing, quality control, and ethical standards to be used by registered public accounting firms.[5] The SEC has oversight and enforcement powers over the PCAOB, but the PCAOB has the power to sanction audit firms and discipline registered public accounting firms and associated persons by revoking registrations and impacting their ability to audit public companies.[6]

A key aspect of Sarbanes-Oxley is the notion of auditor independence and avoidance of conflicts. "Congress came down firmly on the side of a stringent definition of auditor independence when it enacted the Sarbanes-Oxley Act…worried that the lure of lucrative contracts for other services created strong incentives for auditors to knuckle under to management pressure, thereby compromising the integrity of the audit."[7] As a result, auditors are now prohibited from providing many additional services to their audit clients, including consulting, bookkeeping, actuarial, investment and legal services.[8] Sarbanes-Oxley authorized the PCAOB to elaborate on these rules and expand the scope of services that auditors are precluded from offering to clients, and thereby further define "auditor independence."

Accordingly, the PCAOB has proposed and adopted a number of ethics and independence rules since its formation, almost all of which have been reviewed and approved by the SEC. In April, the PCAOB announced that the SEC had approved its latest Ethics and Independence Rules Concerning Independence, Tax Services and Contingent Fees. These rules establish general obligations 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 and identify circumstances in which the provision of tax services impairs an auditor's independence. Included is Rule 3523, which states that a public accounting firm is not independent of its audit clients if the firm provides tax services to certain members of management who serve in financial reporting roles. Rule 3523 therefore expands the list of services an audit firm is prohibited from providing its audit clients (and their executives) in order to maintain its independence.

Public Reaction to Rule 3523

Rule 3523, entitled "Tax Services for Persons in Financial Reporting Oversight Roles" provides that:

> A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period provides any tax service to a person in a financial reporting oversight role at the audit client, or an immediate family member of such person, unless:
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> (a) the person is in a financial reporting oversight role at the audit client only because he or she serves as a member of the board of directors or similar management or governing body of the audit client;
>
> (b) the person is in a financial reporting oversight role at the audit client only because of the person's relationship to an affiliate of the entity being audited—
>
> (1) whose financial statements are not material to the consolidated financial statements of the entity being audited; or
>
> (2) whose financial statements are audited

by an auditor other than the firm or an associated person of the firm; or

(c) the person was not in a financial reporting oversight role at the audit client before a hiring, promotion, or other change in employment event and the tax services are—

(1) provided pursuant to an engagement in process before the hiring, promotion, or other change in employment event; and

(2) completed on or before 180 days after the hiring or promotion event.

Defining 'Oversight Role'

In defining the term "financial reporting oversight role," the PCAOB adopted the SEC's definition which includes "any person who has direct responsibility for oversight over those who prepare the issuer's financial statements and related information (for example, management's discussion and analysis) that are included in filings with the Commission."[9] According to the PCAOB, the rule addresses concerns that performing tax services for such individuals creates an appearance of mutual interest between the auditor and those individuals.[10]

Indeed, while preparing tax returns for individual executives may not be highly lucrative work for large accounting firms, the tax work provides yet another avenue for accountants to cement their relationship with their clients' significant decision-makers.

The new rules take effect on Oct. 31, 2006, and therefore do not apply to tax services being provided pursuant to an engagement already in process on the date the rules were approved and adopted by the SEC, so long as those pre-existing engagements are completed on or before Oct. 31, 2006.

Public Comment

Before the adoption of proposed rules, both the PCAOB and the SEC provide for a period of public comment. With respect to Rule 3523, the PCAOB observed that general comments received from groups representing investors and issuers, as well as several large accounting firms, expressed support for the proposed rule "on the ground that it is necessary to preserve the objectivity, and the appearance of objectivity, of auditors." However, a number of smaller accounting firms, accounting associations and a few issuers opposed the rule as unnecessary, arguing that these types of services have long been provided and that "auditors should be allowed to provide senior financial management of issuers with the same types of tax services the auditor may provide the issuer." Despite this opposition, the PCAOB determined to adopt Rule 3523, finding that an unacceptable appearance of conflict is created where the outside auditor of a company also provides tax services for that company's senior management.[11]

The PCAOB also received specific comments on various aspects of the proposed rule, which led to minor modifications of the published draft. Noting confusion as to whether Rule 3523 was intended to apply to directors of an audited organization, the PCAOB modified the rule to explicitly exclude directors or "any person who serves in a financial reporting oversight role 'only because he or she serves as a member of the board of directors or similar management or governing body of the audit client.'" In addition, the PCAOB excluded from the rule's reach those employees in a financial reporting oversight role at an affiliate of the audit client where: (1) the financial statements of the affiliate are not material to the financial statements of the audit client; or (2) the affiliate's financial statements are audited by an auditor other than the firm conducting the audit of the primary company.[12]

Commenters also expressed concern that Rule 3523 might apply unfairly to individuals subject to the rule because they are hired or promoted into a financial oversight role at an audit client. To address this concern, the PCAOB created a time-limit exception to the rule, making it inapplicable to such individuals when the tax services are: (1) provided pursuant to an engagement that was in process before the hiring, promotion, or other change in employment event, and (2) completed on or before 180 days after said event.[13]

In defining "financial reporting oversight role," the Accountant Oversight Board adopted the SEC's definition which says any person who has direct responsibility for oversight over those who prepare the issuer's financial statements that are included in filings with the commission.

Finally, the PCAOB addressed comments that the proposed rule should be expanded to include all non-audit services and applied to individuals outside the definition of "financial reporting oversight role." Noting that the proposed rule was intended to address concerns that have arisen in relation to auditors' provisions of tax services to executives of public companies, the PCAOB declined to extend the limits of the rule, but noted that it would monitor its implementation and stated that "to the extent that issuers pay for non-audit services provided to any individuals, audit committees can and should be scrutinizing the potential effects on the auditor's independence due to such services."[14]

In its release announcing the approval of the PCAOB's proposed ethics and independence rules, including Rule 3523, the SEC noted that it too had received comments from the American Institute of Certified Public Accountants and a number of large accounting firms, including KPMG and Ernst & Young. These commenters expressed concerns that the proposed rule extended the definition of "financial reporting oversight role" to a broader group of individuals than the SEC's definition included. Specifically, these organizations objected to the inclusion of individuals at material affiliates into the definition of the term. Noting that this issue had not been raised during the PCAOB's comment period because it did not arise until after the PCAOB added exclusionary language for individuals at immaterial subsidiaries, the SEC stated that it would "encourage the PCAOB to issue additional guidance" on the issue. Notwithstanding this issue, the SEC indicated its intention to adopt the proposed rules, stating that Rule 3523 in particular was "within the scope of the PCAOB's authority, particularly its authority to establish ethical standards."[15]

Another Restriction

The adoption of Rule 3523 reflects yet another restriction on the services that auditors of public companies can provide, now limiting the universe of clients available to such firms. Even if the incremental financial cost of this additional limitation is not material to the largest accounting firms, it may have a significant impact on the bottom line of some smaller firms. More importantly, Rule 3523 reflects an expansion of concern with the appearance of impropriety created by professional relationships between auditors and their public clients, and the increased desire to regulate those relationships.

1. See, e.g., 148 CONG. REC. S6526 (daily ed. July 10, 2002) (comments of Sen. Sarbanes) ("it is very clear, as this issue has unfolded, that [Congress] needs to make structural changes. We need to change the system so that the so-called gatekeepers are doing the job they are supposed to be doing. That has not been happening."); 148 CONG. REC. S7351 (daily ed. July 25, 2002) (comments of Sen. Sarbanes to Senate Committee) (the "legislation establishes a carefully constructed statutory framework to deal with the numerous conflicts of interest that in recent years have undermined the integrity of our capital markets and betrayed the trust of millions of investors…[and] establishes a strong independent accounting oversight board, thereby bringing to an end the system of self-regulation in the accounting profession which, regrettably, has not only failed to protect investors, as we have seen in recent months, but which has in effect abused the confidence in the markets, whose integrity investors have taken almost as an article of faith").
2. Pub. L. 107-204, 116 Stat. 745, Title I, Public Company Accounting Oversight Board, §§ 101-109.
3. See http://www.pcaobus.org/.
4. Pub. L. 107-204 at § 101(c).
5. Id. at §103(a)(1). The PCAOB has adopted certain pre-existing standards, such as the Generally Accepted Auditing Standards ("GAAS") issued by the American Institute of Certified Public Accountant, as its interim standards to be used on an initial, transitional basis. See PCAOB Auditing Standard No. 1 (available at http://www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standard_1.pdf).
6. Id. at §105.
7. A.C. Pritchard, "The Irrational Auditor and Irrational Liability" 10 Lewis & Clark Law Review 19 (Spring 2006).
8. See Securities Exchange Act §10A(g), 15 U.S.C. § 78j-1(g) (2000).
9. See PCAOB Release No. 2005-014 at p. 34, fn. 65 (July 26, 2005) (available at http://www.pcaobus.org/Rules/Docket_017/2005-07-26_Release_2005-014.pdf).
10. Id. at p. 35.
11. PCAOB Release No. 2005-014 at p. 35.
12. Id. at pp. 35-36.
13. Id. at pp. 36-37; Rule 3523(c).
14. Id. at pp. 37-38.
15. Securities and Exchange Commission Release No. 34-53677 at pp. 8-9 (April 19, 2006) (available at http://www.sec.gov/ rules/pcaob/2006/34-53677.pdf).

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