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## **A COMPARATIVE ASSESSMENT OF EU, UK, FRENCH, US, AUSTRALIAN AND JAPANESE RESPONSES TO AUDITOR INDEPENDENCE: THE CASE OF NON-AUDIT TAX SERVICES**

RICHARD THOMPSON AINSWORTH

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## A Comparative Assessment of EU, UK, French, US, Australian and Japanese Responses to Auditor Independence: The Case of Non-Audit Tax Services

Auditor independence was a global concern of financial regulators in the 1990's. Some observers saw this in a positive light, a natural development. Adjusting auditor independence rules was a manifestation of global convergence in corporate governance structures.<sup>1</sup> New rules, especially rules leaning toward a harmonized system were welcome.

There was a more sobering view. This view held that global regulators were less concerned with convergence than they were with a sense of impending disaster. Things had gone too far. Significant, maybe even radical change was needed. The independence of corporate auditors had eroded; trust had been fundamentally compromised in the quest for audit firm profits. Corrective measures were needed immediately to avert widespread financial collapse.

The new century did bring startling events: the collapse of HIH (March, 2001)<sup>2</sup> and One.Tel (July, 2001)<sup>3</sup> in Australia; the bankruptcy of Enron (October, 2001),<sup>4</sup> and WorldCom (June, 2002)<sup>5</sup> in the US. In the EU similar scandals broke. There was

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<sup>1</sup> Considerable academic discussion has focused on the global convergence of corporate governance practices. See for example: L. A. Bebchuk and M. J. Roe, "A Theory of Path Dependence in Corporate Ownership and Governance," (1999) 52 *Stan L Rev* 127; A. N. Licht, "The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems," (2001) 26 *Del J of Corp L* 147; L. E. Ribstein, "Politics, Adaptation and Change," (2001) 8 *Aust Jnl of Corp L* 246; and R. Romano, "A Cautionary Note on Drawing Lessons from Comparative Corporate Law," (1993) 102 *Yale L J* 2021.

Some have seen this convergence "coinciding with the civil/common law divide" (Paul von Nessen, "Corporate Governance in Australia: Converging with International Norms," (2003) 15 *Aust Jnl of Corp L* 1, 47, n. 73 citing further to P.G. Maloney, "The Common Law and Economic Growth: Hayek Might Be Right," (2001) 30 *J Leg Stud* 503). This "divide" is not apparent in the response of the Japanese government to the auditor independence issue considered in this paper.

<sup>2</sup> HIH was the largest general insurance company in Australia. Accounting entries hid claims that exceeded accounting reserves, forcing the company's liquidation. See: HIH Royal Commission (Justice Neville Owen), *Report of the HIH Royal Commission*, 2003 at <http://www.hihroyalcom.gov.au/finalreport/> and M. De Martinis, "Do directors, regulators, and auditors speak, hear and see no evil? Evidence from the Enron, HIH and One.Tel collapses." (2003) 15 *Aust. Jnl of Corporate Law* 66.

<sup>3</sup> One.Tel was one of Australia's largest telecommunications companies. One.Tel paid high performance bonuses to the directors as the company was on the verge of collapsing. That internal incentives could have rewarded directors of a failing company outraged Australians and accelerated reform efforts there.

<sup>4</sup> Enron was the seventh largest company in the US. Sham transactions involving Caymen Island entities improperly inflated asset values. See: Peter Behr and April Witt, *Visionary's Dream Led to Risky Business: Opaque Deals, Accounting Sleight of Hand Built an Energy Giant and Ensured Its Demise*, Washington Post, July 28, 2002, at A-1.

<sup>5</sup> WorldCom was the second-largest long distance carrier in the US. Expenses for client development were books as assets. See: Carrie Johnson and Ben White, *WorldCom Arrests Made: Two Former Executives Charged with Hiding Expenses*, Washington Post, August 2, 2002, at A-1.

Vivendi (July 2002) in France, Ahold (February, 2003)<sup>6</sup> in the Netherlands, and Parmalat (February, 2003)<sup>7</sup> in Italy. Were the early years of this century a time of global convergence or a time of financial collapse attributable to widespread accounting failure?

This paper considers global changes in the regulation of the statutory corporate auditor. It focuses on non-audit tax services as an instance where real movement toward convergence of corporate governance can be seen.

## I. Improving Auditor Independence Regulation

### A. European Union

*Auditor independence in the EU.* During the 1990's the convergence of accounting regulation was a major concern in the EU. The lack of a harmonized position on the role, position and liability of the statutory auditor was seen as a barrier to the development of the Single Market. Not only was the quality of European audits impacted, but the EU also felt handicapped when it tried to influence international accounting standards. This convergence theme was advanced in a Green Paper (1996),<sup>8</sup> and was soon followed by a Communication from the Commission (1998),<sup>9</sup> a Consultative Paper (2000),<sup>10</sup> a Commission Recommendation (2000),<sup>11</sup> and finally a comprehensive study of auditor liability (2001).<sup>12</sup>

When Enron broke in October 2001, Europeans characterized it as primarily a US problem, one that, "... brought to light a number of significant international policy issues." In simple terms, the problem was the US preference for a "rules based approach to financial reporting." The EU, in contrast, "... strongly promoted a strategy based on a principles-based approach to financial reporting, [one that was] designed to reflect economic reality and give[s] a true and fair view of the financial position and performance of a company. ... the heart of the [European] Union's strategy [was] the application, from 2005, of International Accounting Standards (IAS) as the reporting framework for all listed EU countries."<sup>13</sup>

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<sup>6</sup> In Ahold earnings were overstated due to improper booking of supplier discounts.

<sup>7</sup> In Parmalat \$3.5 billion in false assets were recorded in Caymen Island subsidiaries.

<sup>8</sup> European Commission, "The Role, the Position and the Liability of the Statutory Auditor within the European Union." 1996 Green Paper. O.J. No C321,28.10.1996. At

[http://europa.eu.int/comm/internal\\_market/en/company/audit/news/staten.pdf](http://europa.eu.int/comm/internal_market/en/company/audit/news/staten.pdf)

<sup>9</sup> Communication from the European Commission, *The Statutory Audit in the European Union: The Way Forward*. 7 May 1998. O.J. No C143,8.5.1998. At:

[http://europa.eu.int/comm/internal\\_market/en/company/audit/news/auditen.pdf](http://europa.eu.int/comm/internal_market/en/company/audit/news/auditen.pdf)

<sup>10</sup> European Commission, *Consultative Paper On: Statutory Auditors' Independence in the EU*. 15 December 2000. At

[http://europa.eu.int/comm/internal\\_market/en/company/audit/news/independence\\_en.pdf](http://europa.eu.int/comm/internal_market/en/company/audit/news/independence_en.pdf)

<sup>11</sup> European Commission Recommendation, *Quality Assurance for the Statutory Audit in the European Union: Minimum Requirements*. 21 November 2000. At

[http://europa.eu.int/smartapi/cgi/sga\\_doc?smartapi!celexap!prod!CELEXnumdoc&lg=en&numdoc=32001H0256&model=guichett](http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexap!prod!CELEXnumdoc&lg=en&numdoc=32001H0256&model=guichett)

<sup>12</sup> European Commission, *A Study on Systems of Civil Liability of Statutory Auditors in the Context of a Single Market for Auditing Services in the European Union*. 15 January 2001. At

[http://europa.eu.int/comm/internal\\_market/en/company/audit/docs/auditliability.pdf](http://europa.eu.int/comm/internal_market/en/company/audit/docs/auditliability.pdf)

<sup>13</sup> European Commission, *A First EU Response to Enron Related Policy Issues*, (12 and 13 April 2002).

At: [http://europa.eu.int/comm/internal\\_market/en/company/company/news/ecofin\\_2002\\_04\\_enron\\_en.pdf](http://europa.eu.int/comm/internal_market/en/company/company/news/ecofin_2002_04_enron_en.pdf)

In May 2003 the European Commission recommended changes in the 8<sup>th</sup> Company Law Directive (84/253/EEC) reflecting this position.<sup>14</sup> Auditor independence rules were part of this initiative.

According to the Commission what Europe needed was a set of harmonized, principles-based financial reporting and auditor independence rules that were based on five generalized “threats” to independence (self-interest; self-review; advocacy; familiarity or trust; intimidation) and their associated “safeguards” (prohibitions, restrictions, policies and procedures, and disclosures within the audit firm, the audit client and governance bodies).<sup>15</sup> The EU methodology relies heavily on documentation. It requires the auditor to demonstrate and document the exercise of good professional judgment. Threats needed to be identified and safeguards applied whenever the situation demanded.

*Non-audit tax services and auditor independence in the EU.* Non audit tax services were not a highlight of this reform. The EU did not consider the provision of non-audit tax services by the statutory auditor to be a separate and distinct “threat” to auditor independence.

Thus, general principles are applied. An auditor who provides non-audit tax advice to a client is required to be alert to the possibility of a “threat” to independence. The auditor is instructed to document both this awareness and the “safeguards” that are considered and utilized to minimize or eliminate this “threat.” A tax-related activity that poses a threat that cannot be adequately minimized is prohibited.

The May 16, 2002 Commission Recommendation does not isolate tax services as a threat to independence. Tax services are not itemized in Article 7, “Non-audit services.” They are not specifically considered in the “General” rules at 7.1 nor are they used in the “Examples – analysis of specific situations” at 7.2. Only Annex 1 mentions non-audit tax services, and in this case they are used as an example of an approved activity, one that poses no threat to independence.

[Routine valuation services involve situations] ... where the underlying assumptions are determined by law (e.g., tax rates, depreciation rates for tax purposes), other regulations (e.g., the

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<sup>14</sup> See: Commission of the European Community, *Communication from the Commission to the Council and the European Parliament: Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward*, COM(2003) 284 final. At: [http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003\\_0284en01.pdf](http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0284en01.pdf)

<sup>15</sup> See: Commission of the European Union, *Commission Recommendation: Statutory Auditors' Independence in the EU: A Set of Fundamental Principles*, at A(3)-(4). At: [http://europa.eu.int/eur-lex/pri/en/oj/dat/202/1\\_191/19120020719en00220057.pdf](http://europa.eu.int/eur-lex/pri/en/oj/dat/202/1_191/19120020719en00220057.pdf) Also: Commission of the European Union, *Proposal for a Directive of the European Parliament and of the Council on Statutory Audit of Annual Accounts and Consolidated Accounts and Amending Council Directives 78/660/EEC and 83/349/EEC*, COM(2004) 177 final; 2004/0065 (COD) at Articles 23 – 25. [http://europa.eu.int/eur-lex/en/com/pdf/2004/com2004\\_0177en01.pdf](http://europa.eu.int/eur-lex/en/com/pdf/2004/com2004_0177en01.pdf)

provision to use certain interest rates), or are widely accepted within the Audit Client's business sector, and when the techniques and methodologies to be used are based on generally accepted standards, or even prescribed by laws and regulations. In such circumstances, the result of a valuation performed by an informed third party, even if not identical, is unlikely to be materially different. The provision of such valuation services might therefore not compromise a statutory auditor's independence, even if the valuation itself could be regarded as material to the financial statements, provided that the Audit Client or its management has at least approved all significant matters of judgment.<sup>16</sup>

In the 2004 Commission Proposal for the EU Directive, non-audit tax services remain unspecified.<sup>17</sup> The underlying assumption seems to be that threats to auditor independence from the provision of tax services are minimal, because the tax authorities regularly audit and assure compliance.

The recommendations of the Commission are not binding EU legislation. The Commission expects to review the country-by-country response to its recommendation in about three years. Binding legislation could follow if the Commission is not satisfied with Member States' application.

*United Kingdom's response to the EU position.* The UK appears to take the provision of non-audit tax services by the statutory auditor more seriously than the Commission. The Secretary of State for Trade and Industry and the Chancellor of the Exchequer established a Co-ordinating Group for Audit and Accounting Issues to examine UK auditor independence rules and make recommendations for regulatory change. The Final Report was issued on January 29, 2003. Although generally adopting the EU principles-based methodology, the Report goes further than the EU with respect to tax services. A "strong case" is made for more "specific guidance" in the area of tax services. It states:

*Taxation Services.* There are no specific requirements or guidance in existing UK Standards, though of course threats to independence have to be considered against the principles of auditor independence referred to at para 1.35 above. The amount of taxation services supplied by the auditor to the company can be considerable. However, the considerations to be taken into account in deciding whether or not to supply them are no different in principle from those that apply to other

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<sup>16</sup> Commission Recommendation of 16 May 2002, *Statutory Auditors' Independence in the EU: A Set of Fundamental Principles*, (2002/590/EC). OJ L 191/22, 19.7.2002. This same approach to non-audit tax services was taken in the related "Consultative Paper on Statutory Auditors' Independence in the EU: A Set of Fundamental Principles," issued December 15, 2000 at section 7.2.3.

[http://europa.eu.int/comm/internal\\_market/en/company/audit/news/independence\\_en.pdf](http://europa.eu.int/comm/internal_market/en/company/audit/news/independence_en.pdf)

<sup>17</sup> Commission of the European Union, *Proposal for a Directive of the European Parliament and of the Council on Statutory Audit of Annual Accounts and Consolidated Accounts and Amending Council Directives 78/660/EEC and 83/349/EEC*, COM(2004) 177 final; 2004/0065 (COD) at Articles 23 – 25. [http://europa.eu.int/eur-lex/en/com/pdf/2004/com2004\\_0177en01.pdf](http://europa.eu.int/eur-lex/en/com/pdf/2004/com2004_0177en01.pdf)

non-audit services. In essence, where the taxation service involves the application of well tried and tested tax law, no difficulties arise. And in any event the tax authorities review the work and generally welcome the close involvement of the auditors. In the circumstances where a particular piece of advice or position taken is material to the financial statements, and where the outcome is subjective or otherwise significantly uncertain, this should be disclosed to the audit committee and careful consideration should be given to the safeguards that must be put in place, including perhaps the need for the company to obtain an independent second opinion. We think therefore that there is a strong case for further consideration by the standard setting body, with a view in particular to the need for specific guidance.<sup>18</sup>

Thus, like the EU, the UK analysis relies heavily on the auditing function of tax authorities. However, where the EU standards seem to approve most tax services, the current UK standards are criticized for their lack of specific guidance on how to analyze the real threats to auditor independence that arise from tax services.

The EU position appears vague, but it is clearly aimed at convergence. It allows for both the UK approach (more specific guidance), as well as the French approach (outright prohibition). The hope is that a way to craft harmonized rules will become apparent during the three year experimental period.

#### B. France

*Auditor independence rules in France.* Auditor independence reforms became law in France while work on the 8<sup>th</sup> Company Directive in the EU progressed. French law had long employed a principles-based approach to auditor regulation. The French National Institute External Auditors (CNCC) and the Commission des opérations de bourse (COB) presented a report in 1997 that supported this approach and rejected a US-styled rules-based system.<sup>19</sup> A post-Enron study by AFEP-AGREF (Association Francaise des Entreprises Privées et Association des Grandes Entreprises Francaises: Association of French Private Sector Companies and Association of Major French Corporations) supported changes in French law, but not in its regulatory methodology. It indicated that "... French companies find themselves in a very different situation from that of their US counterparts. In many respects, French companies are better protected against the risk of excessive or misguided practices."<sup>20</sup>

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<sup>18</sup> Co-ordinating Group for Audit and Accounting Issues, *Final Report*, January 29, 2003, page 32. At: <http://www.dti.gov.uk/cld/cgaai-final.pdf>

<sup>19</sup> CNCC/COB Working Group on Independence and Objectivity of the Statutory Auditors of Public Companies, *Summary of the December 1997 Report*, (3 April 1998) [in English] at: [http://www.amf-france.org/styles/default/documents/general/4151\\_1.pdf#xml=http://www.amf-france.org:80/snqhilight/xml104](http://www.amf-france.org/styles/default/documents/general/4151_1.pdf#xml=http://www.amf-france.org:80/snqhilight/xml104)

<sup>20</sup> AFEP-AGREF, *Promoting Better Corporate Governance in Listed Companies*, 23 September 2002. At: [http://www.medef.fr/staging/medias/upload/367\\_FICHER.pdf](http://www.medef.fr/staging/medias/upload/367_FICHER.pdf)

The French response was the *Loi de Sécurité Financière*. This law modified the content, but not the underlying theory of French auditor independence rules. It was approved July 17, 2003, and published August 2, 2003.<sup>21</sup>

*Non-audit tax services and auditor independence in France.* The *Loi de Sécurité Financière* prohibits the auditor from performing any non-audit services. No distinction is drawn among types of non-audit tax services. Thus, the French view, like that of the UK, is fully compatible with the EU position on auditor independence. However, France has staked out an extreme position. Under French law performing non-audit tax services poses such a “threat” to auditor independence that there is no acceptable “safeguard.”<sup>22</sup>

### C. United States

*Auditor independence in the US (pre-Sarbanes-Oxley).* On June 30, 2000, the US the Securities and Exchange Commission (SEC) under Chairman Arthur Levitt proposed revisions to the SEC’s auditor independence rules.<sup>23</sup> These amendments were adopted on November 21, 2000. They were fashioned through compromise; blending what the SEC proposed with what the accounting profession would accept. They are classic examples of rules-based regulation. Nine types of non-audit services were deemed to be inconsistent with auditor independence. Most of the prohibitions were severely limited. All but three (management, broker-dealer and legal services) were riddled with exceptions.

*Non-audit tax services and auditor independence in the US (pre-Sarbanes-Oxley).* The Levitt reforms, like the EU proposals and the current UK standards, treat tax services as a special category of non-audit services. They were generally deemed to be immune from auditor independence problems because of IRS oversight. “... [A]n accountant's independence should not be deemed impaired when the accountant performs appraisal or valuation services as a necessary part of permitted tax services. As the rule text and this Release make clear, accountants will continue to be able to provide tax services to audit clients. ... [and even with respect to contingency fee arrangements] tax services generally do not create the same independence risks as other non-audit services.”<sup>24</sup>

This is not to say that the SEC did not raise questions about an auditor’s independence when providing tax services. The questions raised about tax services just did not survive the in the Final Rules. At III(D)(1)(b)(xi) the Proposed Rules stated:

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<sup>21</sup> The *Loi de Sécurité Financière* is published in the Official French Journal, 2 August 2003. In French at: <http://www.legifrance.gouv.fr/Waspad/UnTexteDeJorf?numjo=ECOX0200186L>

<sup>22</sup> This opinion is not limited to the French government. Respected opinion is the US would agree with a very restricted role for the statutory auditor. See for example Harvard Law School Professor Bernard Wolfman’s letter to the SEC at the time the SEC was drafting the Sarbanes-Oxley rules on auditor independence. “To assure auditor independence the Commission must require that auditors of public companies stick to auditing, leaving consulting (including all tax services other than return preparation and compliance work) to others.” At: <http://www.sec.gov/rules/proposed/s74902/bwolfman1.txt>

<sup>23</sup> SEC, *Final Rule: Revision of the Commission’s Auditor Independence Requirements*, RIN 3235-AH91 (October 12, 2001). At: <http://www.sec.gov/rules/final/33-7919.htm>

<sup>24</sup> SEC, *Final Rule: Revision of the Commission’s Auditor Independence Requirements*, RIN 3235-AH91 (October 12, 2001). At: <http://www.sec.gov/rules/final/33-7919.htm>



Tax services. The proposed rule would not affect tax-related services provided by auditors to their audit clients. Tax services are unique, not only because there are detailed tax laws that must be consistently applied, but also because the Internal Revenue Service has discretion to audit any tax return. We do not think that the Congressional purpose for requiring independent audits is thwarted by an accountant providing traditional tax preparation services to an audit client or an affiliate of an audit client. We are considering whether special considerations apply when the auditor provides a tax opinion for the use of a third party in connection with a business transaction between the audit client and the third party. ... Under those circumstances, the auditor may be acting as an advocate ... We request comment on whether providing tax opinions, including tax opinions for tax shelters, ... would impair, or would appear to reasonable investors to impair, an auditor's independence. ... Are there other tax-related services that if provided to an audit client, would impair, or would appear to reasonable investors to impair, an auditor's independence?<sup>25</sup>

For the Levitt reforms, the final outcome was that “special considerations” were not deemed necessary for tax services. However, the fact that the collapse of Enron, WorldCom, Tyco and others appeared to have tax, as well as financial motivations, encouraged the SEC to revisit the tax services issue under Sarbanes-Oxley.

*Auditor independence in the US (post-Sarbanes-Oxley).* Section 201(a) of Sarbanes-Oxley codified the auditor independence rules of the Levitt reforms. However, changes were made. Section 201(a) eliminates all the exceptions and limitations to prohibited services that had crept into the rules through compromise with the accounting profession.

Eliminating exceptions was more than a reaction to Enron, it constituted a change in regulatory theory. It was the first sign that Congress expected the SEC to shift the US away from a rules-base regulatory methodology toward a more principles-based set of standards. The SEC observed, “... we interpret the legislative history as indicating (1) Congress did not intend the rules to contain broad categorical exceptions and (2) the scope of the prohibited services should be judged against three basic principles. Those three broad principles are that an auditor cannot (1) audit his or her own work, (2) perform management functions, or (3) act as an advocate for the client. To do so would impair the auditor’s independence. ... We assume, therefore, that Congress intended the Commission to revise its existing rules, at a minimum, to eliminate categorical exceptions and exemptions.”<sup>26</sup>

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<sup>25</sup> SEC, *Proposed Rule: Revision of the Commission’s Auditor Independence Requirements*, RIN 3235-AH91 (June 30, 2000). At: <http://www.sec.gov/rules/proposed/34-42994.htm>

<sup>26</sup> SEC, *Strengthening the Commission’s Requirements Regarding Auditor Independence*, (December 2, 2002) RIN 3235-AI73 at II (B). At: <http://www.sec.gov/rules/proposed/33-8154.htm>.

These “three broad principles” had a history. They had been incorporated into the *Preliminary Note* to Rule 2-01 of Regulation S-X, 17 CFR 210.2-01 in the Levitt reforms. Now they were to guide the SEC as it drafted new rules on auditor independence.

*Non-audit tax services and auditor independence in the US (post-Sarbanes-Oxley).* The SEC and the PCAOB are both moving ahead in the area of tax services. New SEC rules made tax services a suspect classification within the field of non-audit services. Where the Levitt reforms had required registrants to report non-audit services in aggregate,<sup>27</sup> the new SEC rules require tax services to be separately itemized.<sup>28</sup>

In addition, the PCAOB has embraced the “three broad principles” that governed the Levitt reforms as guiding principles controlling further regulatory efforts. A July 14, 2004 Roundtable was organized to solicit comments on the relationship of these principles, auditor independence, and tax services. The following specific areas of tax services were isolated for investigation: (a) tax compliance services (b) tax planning and advisory services, (c) tax strategy services, and (d) executive and international assignment tax services.<sup>29</sup>

Is the US moving closer to a principles-based system of auditor independence regulation? In the area of tax services, the answer appears to be “yes,” but the US approach to this methodology is far more detail-oriented, and case specific than the EU’s approach. These are steps toward a global convergence in standard setting.

Taken together, the actions of the Congress, the SEC and the PCAOB seem to confirm a conscious effort to change and accommodate. Congress pushed both the SEC and the POCAOB in this direction when it required in section 108(d) of Sarbanes-Oxley Act that a study be prepared on *The Adoption by the United States Financial Reporting System of a Principles-Based Accounting System*.

#### D. Australia

*Auditor independence rules in Australia.* Australia began a comprehensive corporate law economic reform program in 1997 (the CLERP initiative). The ninth package of reforms in this initiative took up the issue of auditor independence, *Corporate*

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<sup>27</sup> “Under the final rule, we are not requiring registrants to describe each professional service or to disclose the fee for each service. ... under the caption “All Other Fees,” the fees billed for all other non-audit services, including fees for tax-related services, rendered by the principal accountant during the most recent year.” SEC, *Final Rule: Revision of the Commission’s Auditor Independence Requirements*, RIN 3235-AH91 (October 12, 2001). At: <http://www.sec.gov/rules/final/33-7919.htm>

<sup>28</sup> “We also believe it is appropriate to add transparency regarding a second category of fees: “Tax Fees.” ... We believe that investors will benefit from being able to consider those fees separately from the “all Other Fees” category. The “Tax Fees” category will capture all services performed by professional staff in the independent accountant’s tax division except those related to the audit as discussed previously. Typically, it would include fees for tax compliance, tax planning, and tax advice.” SEC, *Final Rule: Strengthening the Commission’s Requirements Regarding Auditor Independence*, (January 28, 2003) at II (H). At: <http://www.sec.gov/rules/final/33-8183.htm>

<sup>29</sup> PCAOB, *Briefing Paper: Auditor Independence and Tax Services Roundtable*, (July 14, 2004). At: [http://www.pcaobus.org/documents/standards/Briefing\\_Paper%20-%20Independence\\_Roundtable.pdf](http://www.pcaobus.org/documents/standards/Briefing_Paper%20-%20Independence_Roundtable.pdf)

*Disclosure: Strengthening the Financial Reporting Framework*, is referred to as CLERP 9. Australia was responding to the domestic and world crisis in auditor independence standards. The reform program was presented to Parliament on December 2, 2003,<sup>30</sup> well after the collapse of HIH (March, 2001) and One.Tel (July, 2001), the passage of Sarbanes-Oxley (30 July 2002), and the *Loi de Sécurité Financière* (17 July 2003). The reforms were enacted June 24, 2004.<sup>31</sup>

CLERP 9 is based on proposals for change from three sources: (1) the Ramsay report *Independence of Australian Company Auditors* (October 2001),<sup>32</sup> (2) the Joint Committee on Public Accounts and Audits *Report 391: Review of Independent Auditing by Registered Company Auditors* (September 2002)<sup>33</sup> and (3) recommendations from the HIH Royal Commission.<sup>34</sup>

The essence of CLERP 9 is the legislative decision that auditor independence was a governmental concern as well as a concern of the accounting profession. Australian reforms are principles-based, because they adopt the rules of the profession which in turn are based on International Accounting Standards. This approach was strongly supported by the Ramsay report, Report 391, and the HIH Royal Commission. The rules go through the familiar process of identifying and documenting “threats” to independence and then the “safeguards” to these threats by the auditor.<sup>35</sup> If the auditor determines that the “safeguards” are ineffective, the professional standard (and now the Corporations Act) mandates prohibition.<sup>36</sup>

The Australian system of auditor oversight is one of shared responsibility; both the government and peer review structures oversee the accounting profession. Thus, ethical rules drafted by the accounting profession essentially define statutory rules for auditor independence.<sup>37</sup> CLERP 9 simply incorporates these rules into the Corporations

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<sup>30</sup> The complete legislations package can be found at [http://www.treasury.gov.au/documents/700/PDF/CLERP\\_Bill.PDF](http://www.treasury.gov.au/documents/700/PDF/CLERP_Bill.PDF)

<sup>31</sup> See: *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004*, No. 103, 2004. At: <http://scaleplus.law.gov.au/html/comact/browse/TOCN.htm>

<sup>32</sup> The Ramsay Report can be found at <http://www.treasury.gov.au/documents/183/PDF/ramsay.pdf>

<sup>33</sup> See: <http://www.aph.gov.au/house/committee/jpaa/indepaudit/reportscript.pdf>

<sup>34</sup> HIH Royal Commission (Justice Neville Owen), *Report of the HIH Royal Commission*, 2003. At: <http://hihroyalcom.gov.au/finalreport>

<sup>35</sup> The threats to independence are: (1) self-interest, (2) self-review, (3) advocacy, (4) familiarity, and (5) intimidation. The safeguards are: (1) safeguards created by the profession, legislation or regulation, (2) safeguards within the client, and (3) safeguards within the audit firm itself. See: Institute of Chartered Accountants in Australia and CPA Australia, *Professional Statement F-1 (Applicable to All Members): Professional Independence*, at 1.22 to 1.37. Available at [http://www.cpaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018\\_9995\\_ENA\\_HTML.htm](http://www.cpaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018_9995_ENA_HTML.htm)

<sup>36</sup> Institute of Chartered Accountants in Australia and CPA Australia, *Professional Statement F-1 (Applicable to All Members): Professional Independence*, at 2.54 to 2.101. Available at [http://www.cpaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018\\_9995\\_ENA\\_HTML.htm](http://www.cpaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018_9995_ENA_HTML.htm)

<sup>37</sup> See: Institute of Chartered Accountants in Australia and CPA Australia, *Professional Statement F-1 (Applicable to All Members): Professional Independence*, at 2.54 to 2.101. Available at [http://www.cpaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018\\_9995\\_ENA\\_HTML.htm](http://www.cpaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018_9995_ENA_HTML.htm)

Act, making them statutorily (as well as ethically) applicable to auditors of Australian corporations. Section 324CA presents the general requirement of auditor independence, and section 324CB prohibits conflicts of interest.

The Institute of Chartered Accountants in Australia lent its support to CLERP 9 in a July 16, 2002 news release, "Australia Ahead of the Game." In this release the Institute favorably compared the Australian principles-based approach with the American rules-based methodology, and characterized Sarbanes-Oxley as a movement by the US closer to the international norm. "[Sarbanes-Oxley is] the first step towards convergence of US standards to the development of comprehensive international accounting standards."<sup>38</sup>

*Non-audit tax services and auditor independence in Australia.* CLERP 9 does not contain a definition of non-audit services. The law does contain a requirement that the Board of Directors provide a statement in the annual report that identifies all non-audit services provided by the audit firm and the fees applicable to each item of non-audit service [Subsection 300(11A) of the Corporations Act]. In addition, a statement by the Directors must indicate that they are satisfied that the provision of non-audit services is compatible with the general standard of independence, and an explanation of why these non-audit services do not compromise audit independence. [Subsection 300(11B) of the Corporations Act].

Detailed consideration of tax services is found in the professional standards. *Professional Statement F.1* contains the following:

The firm may be asked to provide taxation services to an audit client. Taxation services comprise a broad range of services including compliance, planning, provision of formal taxation opinions, and assistance in the resolution of tax disputes. Such assignments are generally not seen to create threats to independence.<sup>39</sup>

An itemization of tax services is set out in Appendix 1 of the *Guidance Notice*. In spite of this detail, the Australian rules do not appear to offer much critical guidance to the professional. All tax services are approved. The only critical limitation being that the auditor must have "appropriate experience and skills."<sup>40</sup>

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[E2901D78/cpa/hs.xsl/1018\\_9995\\_ENA\\_HTML.htm](http://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018_9995_ENA_HTML.htm) Also see: The Auditing and Assurance Standards Board of the Australian Accounting Research Foundation, *Auditor Independence*, Guidance Note, March 2003 at Appendix 1, 1-2. Available at: <http://www.aarf.asn.au/docs/NewGuidanceNoteMarch2003.pdf>

<sup>38</sup> The Institute of Chartered Accountants in Australia, *Australia Ahead of the Game*, at <http://www.icaa.org.au/news/index.cfm?menu=269&id=A105172188>

<sup>39</sup> Institute of Chartered Accountants in Australia and CPA Australia, *Professional Statement F-1 (Applicable to All Members): Professional Independence*, at 2.77. Available at [http://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018\\_9995\\_ENA\\_HTML.htm](http://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018_9995_ENA_HTML.htm)

<sup>40</sup> The listed services are: (1) acting as tax agent; (2) tax advice in relation to income tax matters; (3) preparation of tax returns on behalf of an entity; (4) tax advisory services, in relation to indirect taxes, for

### E. Japan

*Auditor independence rules in Japan.* Japan took an entirely different path to improving auditor independence. Seemingly immune from the wave of accounting-related corporate collapses, Japan did not implement reforms until April 2004. Japan even waited after it learned of Enron, WorldCom, HIH, One.Tel, Vivendi, Ahold and Parmalat.

Japan responded, not to accounting failures but to the wave of overseas regulatory reforms that threatened to impact Japanese businesses and the Japanese accounting profession itself. The defining event for Japanese regulators was section 106(a) of Sarbanes-Oxley. This is the extra-territorial enforcement provision of the Act whereby the SEC and PCAOB are authorized to oversee foreign accounting firms if they perform statutory audits for firms listed on US exchanges.<sup>41</sup> When the PCAOB initiated rulemaking procedures<sup>42</sup> that would potentially bring Japanese auditing firms under direct US oversight, Japan began to replace its peer review system with an independent regulatory structure.<sup>43</sup>

The PCAOB is willing to rely on investigation by non-US authorities, after an evaluation of the “independence and rigor” of the foreign system. Local law, the independence of the agency, its funding, transparency and its history of performance are all considered.<sup>44</sup>

Japan’s response to Sarbanes-Oxley has two aspects: (a) the Japanese legislature amended the “Certified Public Accountant Law” (*Kouninkaikeishihou* 1948-8-1) through “An Act to Amend Part of the Certified Public Accounting Law” (*Kouninkaikeishihou no ichibu wo kaisei suru houritsu* 2004-4-1), and (b) the Japanese government issued Cabinet Office Ordinances (*Naikakuhurei* 2004-4-1). In the law, promulgated June 6, 2003, a new government oversight and inspection agency, the CPA and Auditing

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example: customs and excise, GST; Sales Tax; Stamp Duty; (5) Tax advice in relation to transfer pricing; (6) tax advisory services in relation to ATO audits; (7) tax advice in relation to employee specific matters, for example: employee share schemes, FBT; and superannuation; (8) tax advisory services in relation to an entity’s employees’ tax return, for example an overseas based employee; (9) tax return preparation for an entity’s employees; (10) expatriate employment and relocation services, for example: Employment contract advice; and relocation coordination. See: The Auditing and Assurance Standards Board of the Australian Accounting Research Foundation, *Auditor Independence*, Guidance Note, March 2003 at Appendix 1, 1-2. Available at: <http://www.aarf.asn.au/docs/NewGuidanceNoteMarch2003.pdf>

<sup>41</sup> See the comments of Naohiko Matsuo, Director for International Financial Markets, Japanese Financial Services Agency responding to the PCAOB’s proposed rules on January 26, 2004. See item 6 in the zip file associated with “Rulemaking Docket Matter 013” at: [http://www.pcaobus.org/rulemaking\\_docket.asp](http://www.pcaobus.org/rulemaking_docket.asp)

<sup>42</sup> These rules were finalized on June 9, 2004. PCAOB, *Final Rules Relating to the Oversight of Non-US Public Accounting Firms*. At: <http://www.pcaobus.org/rules/Release2004-005.pfd>. They were forwarded on to the SEC for final approval on June 17, 2004. At: <http://www.pcaobus.org/documents/rulemaking/013/PCAOB%202004-04%20Form%2019b-4%20for%20International%20Rules%20-%20June%2017%202004.pdf>.

<sup>43</sup> PCAOB, *Proposed Rules Relating to the Oversight of Non-US Public Accounting Firms*, (December 10, 2003). At: <http://www.pcaobus.org/rules/Release2003-024.pfd>.

<sup>44</sup> PCOAB Proposed Rule 4012. At PCAOB, *Final Rules Relating to the Oversight of Non-US Public Accounting Firms*, page A1-2. At: <http://www.pcaobus.org/rules/Release2004-005.pfd>.

Oversight Board (CPAAOB) was established. In the Cabinet Ordinance at Article 5 rules on auditor independence were published.

The Cabinet Ordinance rules are a literal translation of Sarbanes-Oxley section 201(a)(1)-(8), and nothing more. Thus, the non-audit services prohibited under Japanese law are a mirror image of the non-audit services that are prohibited under US law. The Japanese law and ordinances were effective April 1, 2004.

*Non-audit tax services and auditor independence in Japan.* The Japanese have no rules on non-audit tax services. Because the prohibitions of sections 201(a)(1)-(8) make no reference to tax services, the same is true of the Japanese law. Tax services, except for those that are indirectly contained within the list of prohibited services under Sarbanes-Oxley, are permitted.<sup>45</sup>

However, section 201(a)(9) of Sarbanes-Oxley grants the PCAOB discretion to extend the list of prohibited non-audit services. As the July 14, 2004 “Auditor Independence and Tax Services Roundtable” indicates, the PCAOB is considering rulemaking in the tax services area, and one would expect that if rules were issued then Japanese law would accommodate a similar change through an update to the Cabinet Ordinance. At least this would appear to be the case with respect to any tax services that the PCAOB determines should be expressly prohibited.

## II. Signs of Convergence

Are there signs of convergence in corporate governance with respect to the provision of non-audit services? The answer is “yes,” in at least two respects.

First, there is general agreement around a common goal: the improvement of investor confidence through the increased reliability of financial statements. Secondly, there is remarkable consensus around the ultimate principles that need to be applied to meet this goal.

In the US these principles were set out in the Levitt reforms. They remain in the *Preliminary Note* to Rule 2-01 of Regulation S-X, 17 CFR 210.2-01, and were unchanged by Sarbanes-Oxley. The Japanese statement of principles follows the US. In the EU, UK, and Australia<sup>46</sup> the same principles, formulated in a different manner, are expressed in terms of threats to auditor independence.<sup>47</sup>

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<sup>45</sup> An indirect prohibition under Sarbanes-Oxley can be seen, for example, in the advocacy prohibition. Because advocacy (representing an audit client in court) is a prohibited activity under section 201(a)(8), so too is tax advocacy (representing an audit client in tax court).

<sup>46</sup> Because the French view is that all non-audit services should be prohibited, France is omitted from this assessment. The French view follows that of the International Federation of Accountants, however from the French perspective threats to independence cannot be mitigated through any safeguard short of absolute prohibition

<sup>47</sup> The common source for these formulations is the International Federation of Accountants, *Code of Ethics for Professional Accountants*, IFAC Ethic Committee, New York, NY (2001).

Viewed side-by-side the harmony in the underlying principles in these alternate formulations is apparent.

<b>US; Japan</b>	<b>EU<sup>48</sup>; UK<sup>49</sup>; Australia<sup>50</sup></b>
1. The auditor should have no mutual or conflicting interest with the client.	Self-interest threat. <sup>51</sup> Familiarity threat. <sup>52</sup> Intimidation threat. <sup>53</sup>
2. The auditor should not audit his or her own work.	Self-review threat (element 1) <sup>54</sup>
3. The auditor should not function as management or as an employee of the client.	Self-review threat (element 2)

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<sup>48</sup> The EU formulation can be found in the *Consultative Paper on Statutory Auditor's Independence in the EU: A Set of Fundamental Principles*, (December 15, 2000) at 3(1) and (2). Available at: [http://europa.eu.int/comm/internal\\_market/en/company/audit/news/independence\\_en.pdf](http://europa.eu.int/comm/internal_market/en/company/audit/news/independence_en.pdf)

<sup>49</sup> The UK framework was introduced in 1997, and was placed into conformance with the EU framework in June 2002 by adopting the "Fundamental Principles" of the EU. See: Institute of Chartered Accountants in England and Wales, *Guide to Professional Ethics: Introduction and Fundamental Principles, Statement 1.200 Revised*, (2002).

<sup>50</sup> The CLERP 9 reforms place these rules into the Corporations Act at sections 324CE(7) and 324CF(7). *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004*, No. 103, 2004. At: <http://scaleplus.law.gov.au/html/comact/browse/TOCN.htm>

<sup>51</sup> "A self-interest threat occurs when a firm or a member of the assurance team could benefit from a financial interest in, or other self-interest conflict with an assurance client." Institute of Chartered Accountants in Australia and CPA Australia, *Professional Statement F-1 (Applicable to All Members): Professional Independence*, at 1.23. Available at [http://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018\\_9995\\_ENA\\_HTML.htm](http://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018_9995_ENA_HTML.htm)

<sup>52</sup> "A familiarity threat occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or a member of the assurance team becomes too sympathetic to the client's interests." Institute of Chartered Accountants in Australia and CPA Australia, *Professional Statement F-1 (Applicable to All Members): Professional Independence*, at 1.26. Available at [http://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018\\_9995\\_ENA\\_HTML.htm](http://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018_9995_ENA_HTML.htm)

<sup>53</sup> "An intimidation threat occurs when a member of the assurance team may be deterred from acting objectively and exercising professional skepticism by threat, actual or perceived, from directors, officers or employees of an assurance client." Institute of Chartered Accountants in Australia and CPA Australia, *Professional Statement F-1 (Applicable to All Members): Professional Independence*, at 1.27 Available at [http://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018\\_9995\\_ENA\\_HTML.htm](http://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018_9995_ENA_HTML.htm)

<sup>54</sup> "A self-review threat occurs when (1) any product or judgment of a previous assurance engagement or non-assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement, or (2) when a member of the assurance team was previously a director or officer of the assurance client or was an employee in a position to exert direct and significant influence over the matter of the assurance engagement." Institute of Chartered Accountants in Australia and CPA Australia, *Professional Statement F-1 (Applicable to All Members): Professional Independence*, at 1.24. Available at [http://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018\\_9995\\_ENA\\_HTML.htm](http://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018_9995_ENA_HTML.htm)

4. The auditor should not act as an advocate for the client. Advocacy threat.<sup>55</sup>

Convergence then is not a matter of agreeing on goals or ultimate principles; it is a matter of developing common implementation schemes, and designing uniform enforcement. This is the area of difference. The US has preferred rules-based standards where most other countries have preferred principles-based standards. However, the US appears to be moving toward convergence. The questions that remain are: (1) has the US moved far enough, and (2) if the US has only moved half-way, and half-way is not enough, will the US be met in the middle?

The SEC has offered an assessment of rules-based and principles-based standards. It has found both to be wanting, and has proposed that rules should be written in a manner that blends rules and principles methods. It calls this an objectives-oriented method of setting standards.<sup>56</sup> The developing US rules on tax services are important because they appear to be the first comprehensive attempt to put this new approach into practice. They form the case study at the end of this paper.

### III. Principles v. Rules-Based Regulation

Two theories of standard-setting, principles-based and rules-based, characterize auditor independence regulation.

*Principles-based regulation.* Concise statements of substantive principles characterize principles-based rules. The regulatory objective is an integral part of the standard. The standard itself is characterized by few, if any, exceptions. Principles-based regulation commonly provides detailed implementation guidance. They are normally devoid of bright-line tests. The standard implements, is consistent with, and is derived from, a coherent overall conceptual framework of corporate governance practices.

*Rules-based regulation.* In contrast, a rules-based approach to standard-setting is characterized by bright-line tests. The standards themselves frequently incorporate exceptions. Voluminous, detailed implementation guidance is usually needed to resolve uncertainties about application of the standard. The underlying vision of a rules-based system is to incorporate within the standard an examination of virtually every imaginable scenario, and provide detailed guidance on the resolution of each fact pattern. In theory, this approach seeks to minimize the need for professional judgment.

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<sup>55</sup> “Advocacy threat occurs when a firm, or a member of the assurance team, promotes, or may be perceived to promote an assurance client’s position or opinion to the point that objectivity may, or may be perceived to be, compromised. Such may be the case if a firm or member of the assurance team were to subordinate their judgment to that of the client.” Institute of Chartered Accountants in Australia and CPA Australia, *Professional Statement F-1 (Applicable to All Members): Professional Independence*, at 1.25. Available at [http://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018\\_9995\\_ENA\\_HTML.htm](http://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018_9995_ENA_HTML.htm)

<sup>56</sup> SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* Available at: <http://www.sec.gov/news/studies/principlesbasedstand.htm>



*Convergence of principles-based and rules-based theories.* Aside from press statements, the best evidence that convergence efforts are underway is found in the SEC's *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System.*<sup>57</sup> In this study the SEC criticizes both principles-only and rules-only standards, and proposes a middle ground of objectives-oriented standard setting.

A principles-only approach is criticized for not providing sufficient guidance to make standards reliably operational. Under a "... principles-only approach auditors are required to exercise significant judgment in applying overly-broad standards to more specific transactions and events..."<sup>58</sup> The SEC saw heavy reliance on judgment as a factor that would result in a loss of comparability among reporting entities, as well as increase the likelihood of litigation.

However, the SEC also criticizes a rules-only approach. "... [A] rules-based standard can provide a roadmap to avoidance of the accounting objectives inherent in the standards. Internal inconsistencies, exceptions and bright-line tests reward those willing to engineer their way around the intent of the standards."<sup>59</sup> The danger here is financial reporting that is not representationally faithful to the underlying economic substance of the transactions and events. The large number of exceptions in rules-based systems leads to internal inconsistencies. Considerable judgment is needed to determine where, within a myriad of exceptions, a transaction falls. A rules-based system fosters technical compliance, more than sincere communication or full and fair disclosure.

*Objectives-oriented standard setting:* The key characteristic of an objectives-oriented standard is that it has few, if any, scope exceptions. A theory of optimal scope governs. This means that it avoids a scope that is too broad, where a standard setter could not provide meaningful and useful guidance, and avoids a scope that is too narrow, where a standard would not have sufficient applicability to cover all transactions of similar economic substance.<sup>60</sup>

As envisioned by the SEC, an objectives-oriented standard would be comprised of five distinct elements:

- (1) It would be based on a consistently applied conceptual framework.
- (2) It would clearly state the accounting objective.

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<sup>57</sup> Available at: <http://www.sec.gov/news/studies/principlesbasedstand.htm>

<sup>58</sup> SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (July 25, 2003) at 6. See: <http://www.sec.gov/news/studies/principlesbasedstand.htm>

<sup>59</sup> SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (July 25, 2003) at 6. See: <http://www.sec.gov/news/studies/principlesbasedstand.htm>

<sup>60</sup> SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (July 25, 2003) at 24. See: <http://www.sec.gov/news/studies/principlesbasedstand.htm>

- (3) It would provide sufficient detail and structure that the standard can be operationalized and applied on a consistent basis.
- (4) It would minimize exceptions from the standard.
- (5) It would avoid use of percentage (“bright-line”) tests that allow financial engineers to achieve technical compliance with the standard while evading its intent.<sup>61</sup>

#### IV. Case Study of Convergence:

In the narrow area of non-audit tax services the SEC appears to be following an objectives-oriented approach to developing standards. The global response to these rules will be a measure of the current convergence opportunity.

Tax services raise some of the most contentious auditor independence issues.<sup>62</sup> The intensity of the controversy is directly related both to how lucrative tax services have become for major accounting firms, as well as how often the auditor’s tax advice has become the source of corporate governance problems.<sup>63</sup> Each of the highly publicized US security scandals involved either the tax positions taken by the companies or the determination of their tax reserves. The cases of Enron,<sup>64</sup> Tyco,<sup>65</sup> and WorldCom<sup>66</sup> are the most prominent examples. It is not surprising that the SEC requires that the fees for tax services are required to be separately itemized in SEC reports.<sup>67</sup>

#### The Old Standard for Tax Services

On June 29, 2000 the SEC proposed a “Revision to the Commission’s Auditor Independence Requirements,”<sup>68</sup> the Levitt reforms. With respect to tax services the release stated:

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<sup>61</sup> SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (July 25, 2003) at 4-5. See: <http://www.sec.gov/news/studies/principlesbasedstand.htm>

<sup>62</sup> For a survey of the empirical literature in the US and UK on this issue see: Vivian Beattie and Stella Fearnley, *Auditor Independence and Non-Audit Services: A Review of the Literature* (2000) at 28-30. At: [http://www.icaew.co.uk/library/index.cfm?AUB=TB21\\_63272.MNXI\\_63272](http://www.icaew.co.uk/library/index.cfm?AUB=TB21_63272.MNXI_63272) For a similar survey from an Australian perspective see the Ramsay Report. <http://www.treasury.gov.au/documents/296/PDF/ramsay2.pdf>

<sup>63</sup> In a survey of SEC audit clients performed by the then Big 5 audit firms, the ratio of accounting and auditing revenues to consulting revenues dropped from approximately 6 to 1 in 1999 to 1.5 to 1 in 1999. For the year 1999, 4% of the Big 5 firm’s SEC audit clients had consulting fees in excess of audit fees, up from 1% in 1990. Panel on Audit Effectiveness, *Report and Recommendations*, (2000) chaired by Shaun F. O’Malley at paragraph 5.14. At: <http://www.pobauditpanel.org/download.html>

<sup>64</sup> Peter Behr and April Witt, *Visionary’s Dream Led to Risky Business: Opaque Deals, Accounting Sleight of Hand Built an Energy Giant and Ensured Its Demise*, Washington Post, July 28, 2002, at A-1

<sup>65</sup> Mark Maremount and Laurie P. Cohen, *New York Prosecutors Seek Auditor Link in Tyco Probe*, Wall Street Journal Europe, September 30, 2002, at A-1.

<sup>66</sup> Carrie Johnson and Ben White, *WorldCom Arrests Made: Two Former Executives Charged with Hiding Expenses*, Washington Post, August 2, 2002, at A-1.

<sup>67</sup> U.S. Securities and Exchange Commission, RIN 3235-AI73 *Strengthening the Commission’s Requirements Regarding Auditor Independence* (January 28, 2003, release date; May 6, 2003, effective date). At: [www.sec.gov/rules/final/33-8183.htm](http://www.sec.gov/rules/final/33-8183.htm).

<sup>68</sup> SEC, *Final Rule: Revision of the Commission’s Auditor Independence Requirements*, RIN 3235-AH91 (October 12, 2001). At: <http://www.sec.gov/rules/final/33-7919.htm>

The proposed rule would not affect tax-related service provided by auditors to their audit clients. Tax services are unique, not only because there are detailed laws that must be consistently applied, but also because the Internal Revenue Service has discretion to audit any tax return. We do not think that the Congressional purpose for requiring independent audits is thwarted by an accountant providing traditional tax preparation services to an audit client or an affiliate of an audit client.

Functionally, the SEC was giving blanket regulatory approval to tax services, primarily because the IRS was presumed to be overseeing this compliance area.

### **New Standards for Tax Services**

#### *The Sarbanes-Oxley Act – Efforts at Convergence Legislatively: Elements 4 & 5 of an Objectives-Oriented Standard*

The fourth element of an objectives-oriented standard is that exceptions must be minimized. The fifth is that bright-line tests must be avoided. The Sarbanes-Oxley Act contributes directly to meeting both of these requirements through its modification of the Levitt regulations.

The Levitt reforms are codified in section 201(a). However, the codification omits all exceptions and limitations. Sarbanes-Oxley eliminated twenty-five distinct exceptions, percentage limitations and bright line tests, each of which had allowed financial engineers to achieve technical compliance with the standard while evading its intent.

#### **Sarbanes-Oxley, Section 201(a)**

(1) “bookkeeping or other services related to the accounting records or financial statements of the audit client;”

#### **Levitt Reforms<sup>69</sup>**

“bookkeeping or other services related to the audit clients accounting records or financial statements ... maintaining or preparing an audit client’s accounting records; preparing financial statements that are filed with the Commission ...; preparing or originating source data underlying the audit client’s financial statements.”<sup>70</sup>

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<sup>69</sup> SEC, *Final Rule: Revision of the Commission’s Auditor Independence Requirements*, RIN 3235-AH91 (October 12, 2001). At: <http://www.sec.gov/rules/final/33-7919.htm>

<sup>70</sup> There are two categories of exceptions at (c)(4)(i)(B) in the Final Rule. The first for “emergency or other unusual situations, provided the accountant does not undertake managerial actions or make managerial decision.” The second is applicable to foreign divisions or subsidiaries. This exception allows six categories of activities, those that are: “(i) ... limited, routine, or ministerial; (ii) ... [where it is] impractical ... to make other arrangements; (iii) ... [where] the foreign division or subsidiary is not material ... (iv) ... [where] a foreign employee is not capable or competent ... (v) [where] the services performed are

(2) “financial information systems design and implementation;”

“Financial information systems design and implementation. Directly or indirectly operating or supervising the operation of, the audit client’s information system or managing the audit client’s local area network. Designing or implementing a hardware or software system that aggregates source data underlying financial statements ...”<sup>71</sup>

(3) “appraisal or valuation services, fairness opinions, or contribution-in-kind reports;”

“Appraisal or valuation services or fairness opinions. Any appraisal service, valuation service, or any service involving a fairness opinion for an audit client where ... material to the financial statements, or where the results of these service will be audited by the accountant...”<sup>72</sup>

(4) “actuarial services;”

“Actuarial services. Any actuarially-oriented advisory service involving the determination of insurance company policy reserves and related accounts ...”<sup>73</sup>

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consistent with local professional ethical rules; (vi) [where] the fees... do not exceed 1% of the consolidated audit fees or \$10,000.”

<sup>71</sup> There are five exceptions at (c)(4)(ii)(B) in the Final Rule. The exceptions are: (1) [when] the audit client’s management has acknowledged in writing ... its responsibility to establish and maintain a system of internal accounting controls ... (2) [where] the audit client’s management designates a competent employee ... with responsibility to make all management decisions ... (3) [where] the audit client’s management makes all management decisions with respect to design and implementation ... (4) [where] the audit client’s management evaluates the adequacy and results of the design and implementation ... (5) [where] the audit client’s management does not rely on the accountant’s work as the primary basis of the design and implementation ...”

<sup>72</sup> There are four exceptions at (c)(4)(iii)(B) in the Final Rule. The exceptions are: “(1) [where] the accounting firm’s valuation expert reviews the work of the audit client ... (2) [where] ... the audit client has determined and taken responsibility for all significant assumptions and data; (3) [where] the valuation is performed in the context of the planning and implementation of a tax-planning strategy or for tax compliance services; (4) [where] the valuation is for non-financial purposes ...”

<sup>73</sup> There are four exceptions at (c)(4)(iv)(B) in the Final Rule. The exceptions are: “(1) [where the accountant] ... assists management to develop appropriate methods, assumptions and amounts for policy or loss reserves ... (2) [where the accountant] assists management in the conversion of financial statements ... (3) [where the accountant] analyzes actuarial considerations and alternatives in federal income tax planning; (4) [where the accountant] assists management in the financial analysis of various matters, such as new policies, new markets, business acquisitions, and reinsurance needs.”

- (5) “internal audit outsourcing services;” “Internal audit services. Either of internal audit services in an amount greater than 40% of the total hours expended on the audit ... any internal audit services, or any operational audit services ...”<sup>74</sup>
- (6) “management functions or human resources;” “Human resources.”<sup>75</sup> ... acting as a negotiator on the audit client’s behalf, such as determining positions, status or title, compensation, fringe benefits or other conditions of employment ... (management functions).”<sup>76</sup>
- (7) “broker or dealer, investment adviser, or investment banking services;” “Broker dealer services. Acting as a broker-dealer, promoter, or underwriter, on behalf of a client ...”<sup>77</sup>
- (8) “legal services and expert services unrelated to the audit” “Legal services. Providing any legal service to a client under circumstances in which the person providing the service must be admitted to practice before courts of a US jurisdiction.”<sup>78</sup>
- (9) “any other service that the Board [PCAOB] determines, by regulation, is impermissible.”

#### *Tax Services in Sarbanes-Oxley*

Sarbanes-Oxley places tax services under that same conceptual framework, controlled by the same general principles as all other non-audit service. The language that does this has been problematical to some. It not only raises the possibility that tax services could be prohibited, it also expresses the opposite position, that some tax services are permissible. The law states:

A registered public accounting firm may engage in any non-audit service, including tax services, that is not described in any of the

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<sup>74</sup> There are five exceptions at (c)(4)(v)(B) in the Final Rule. The exceptions are: (1) [when] the audit client’s management has acknowledged in writing ... its responsibility to establish and maintain a system of internal accounting controls ... (2) [where] the audit client’s management designates a competent employee ... to be responsible for the internal audit function ... (3) [where] the audit client’s management determines the scope, risk, and frequency of internal audit activities ... (4) [where] the audit client’s management evaluates the findings and results arising from internal audit activities ... (5) [where] the audit client’s management evaluates the adequacy of the audit procedures performed... (6) [where] the audit client’s management does not rely on the accountant’s work as the primary basis for determining the adequacy of its internal controls.”

<sup>75</sup> No exceptions.

<sup>76</sup> No exceptions.

<sup>77</sup> No exceptions.

<sup>78</sup> No exceptions.

paragraphs (1) through (9) ... only if the activity is approved by the audit committee of the issuer, ...<sup>79</sup>

Distinguishing between permissible and impermissible tax services in accordance with the same principles that govern other non-audit services is left for SEC regulation and PCAOB rulings.

*SEC Regulation – Contributions to Convergence:  
Elements 1 & 2 of an Objectives-Oriented Standard*

The first and second elements of an objectives-oriented standard are: (1) that it is based on a consistently applied conceptual framework and, (2) that it clearly states the regulatory objective.

*The Conceptual Framework:  
Element 1 in an Objectives-oriented Standard*

A consistently applied conceptual framework is applied to all non-audit services. SEC regulation makes it clear that a three-part structure is applied to determine the appropriateness of any non-audit service. Non-audit services are either (a) allowed and approved by the audit committee; or (b) allowable but not approved by the audit committee; or they are (c) prohibited because they violate one or more of the governing principles.<sup>80</sup> The audit committee discriminates between audit services in category (a) and (b) by weighing efficiency and investor protection considerations.<sup>81</sup>

This conceptual framework is consistently applied to all non-audit services, including tax services. The SEC explains how to use the framework to determining whether or not a tax service is permissible (a) or (b) above, or prohibited (c). The decision maker should reason by analogy to the other prohibited services, and be guided in this analogy by an application of the regulatory objective: auditor independence.

For example, the SEC states that because there is no “bright-line” excluding tax services, “... merely labeling a service as a ‘tax service’ will not necessarily eliminate its potential to impair independence under Rule 2-01(b).”<sup>82</sup> The proper analysis is to observe that, because providing legal services for a client is prohibited, an auditor should understand that, “... representing an audit client before a tax court, district court or federal court of claims [is also prohibited].”<sup>83</sup>

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<sup>79</sup> Section 201(a) of the Sarbanes-Oxley Act.

<sup>80</sup> Wardell, Thomas, *International Accounting Standards in the Wake of Enron: The Current State of Play under the Sarbanes-Oxley Act of 2002*, 28 North Carolina Journal of International Law and Commercial Regulation, 935 (Summer, 2003); *The Good the Bad and Their Corporate Code of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior*, 116 Harvard Law Review, 2123 (May, 2003).

<sup>81</sup> Durst, Michael C. & Thomas H. Gibson. “Audit” vs. Non-Audit” Tax Services under Sarbanes-Oxley. *The Tax Executive* (November-December, 2003) 474-477.

<sup>82</sup> SEC, *Final Rule: Strengthening the Commission’s Requirements Regarding Auditor Independence*, (January 28, 2003) at II (B) (11). At: <http://www.sec.gov/rules/final/33-8183.htm>

<sup>83</sup> SEC, *Final Rule: Strengthening the Commission’s Requirements Regarding Auditor Independence*, (January 28, 2003) at II (B) (11). At: <http://www.sec.gov/rules/final/33-8183.htm>

*The Clearly Stated Objective  
Element 2 in an Objectives-oriented Standard*

The SEC also makes it clear that the same basic objectives are applicable to all non-audit services. These “simple principles” of auditor independence are discussed in the final regulations:

... the principles of independence with respect to services provided by auditors are largely predicated on three basic principles, violations of which would impair the auditor's independence:

- (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 own client.<sup>84</sup>

Although presented here as three, rather than four, principles<sup>85</sup> the SEC expressly references the “basic principles” of auditor independence placed by the Levitt reforms in the *Preliminary Note* to Rule 2-01 of Regulation S-X, 17 CFR 210.2-01. Senator Sarbanes spelled out the same standards during Senate floor debates.<sup>86</sup>

*Rulemaking Convergence Efforts -- PCAOB Rulemaking:  
Element 3 of an Objectives-Oriented Standard*

The third element in an objectives-oriented standard is that the standard must provide sufficient detail and structure so that the standard can be operationalized and applied on a consistent basis.

This aspect of an objectives-oriented standard for tax services is not finalized at the time of this writing. The PCAOB recognizes the need for added “detail and structure” in this area, and initiated a rulemaking project on July 14, 2004 to “... consider the impact of tax services on auditor independence.”<sup>87</sup> A Roundtable was held, signaling the beginning of this rulemaking process. The PCAOB is considering rules in the following areas:

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<sup>84</sup> SEC, *Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence*, effective May 6, 2003; [www.sec.gov/rules/final/33-8183.htm](http://www.sec.gov/rules/final/33-8183.htm). See also: PCAOB, *Briefing Paper: Auditor Independence Roundtable*, (July 14, 2004) at 4. See:

[http://www.pcaobus/documents/standards/Briefing\\_Paper%20-%20Independence\\_Roundtable.pdf](http://www.pcaobus/documents/standards/Briefing_Paper%20-%20Independence_Roundtable.pdf)

<sup>85</sup> There seems to be some ambiguity with respect to whether there are three or four principles. In its *Briefing Paper: Auditor Independence and Tax Services Roundtable*, the PCAOB specifically recites, without comment, the “four overarching principles that inform the Commission’s application of the general standard of independence,” and in the next paragraph recites the shorter list of “three basic principles.” (pages 4-5). Perhaps the first principle, that the auditor cannot perform an activity that would create a mutual or conflicting interest between the accountant and the audit client, is deemed to be a further abstraction of the other three principles dealing with functioning as management, auditing his own work, and advocating for the client. See: [http://www.pcaobus/documents/standards/Briefing\\_Paper%20-%20Independence\\_Roundtable.pdf](http://www.pcaobus/documents/standards/Briefing_Paper%20-%20Independence_Roundtable.pdf)

<sup>86</sup> Senate Report 107-205, 107<sup>th</sup> Cong., 2d Sess., July 3, 2002),

<sup>87</sup> PCAOB, *Briefing Paper: Auditor Independence Roundtable*, (July 14, 2004) at 3. See: [http://www.pcaobus/documents/standards/Briefing\\_Paper%20-%20Independence\\_Roundtable.pdf](http://www.pcaobus/documents/standards/Briefing_Paper%20-%20Independence_Roundtable.pdf)

- tax compliance services (preparation of original and amended returns, planning estimated tax payments, and preparation of return extensions at all levels of government – local, state, federal and international jurisdictions);
- tax planning and advisory services (the treatment of mergers and acquisitions, executive compensation, employee benefit plans, proposed or pending tax legislation, and international tax requirements like trade and customs duties);
- tax strategy services (tax-motivated, structured transactions that enable a company to reduce tax liability or achieve a financial accounting result);
- executive and international assignment tax services.<sup>88</sup>

As expected, the range of opinions at the Roundtable was diverse. Some argued that the auditor should be prohibited from engaging in any tax services,<sup>89</sup> while others argued for great latitude in the rules.<sup>90</sup> There was however, unanimous agreement that whatever rules were to be drafted, they should follow logically from the “basic principles” first set out in the Levitt reforms.<sup>91</sup>

### Conclusion

The US has responded to the most serious criticisms of its rules-only-based method of setting standards. With respect to non-audit services generally, the US has eliminated exceptions, limitations, bright-line and percentage tests. Specifically in the area of tax services, the US is directly tying principles with operational rules. This represents a significant movement toward a principles-based method of setting standards.

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<sup>88</sup> PCAOB, *Briefing Paper: Auditor Independence Roundtable*, (July 14, 2004) at 4-8. See:

[http://www.pcaobus/documents/standards/Briefing\\_Paper%20-%20Independence\\_Roundtable.pdf](http://www.pcaobus/documents/standards/Briefing_Paper%20-%20Independence_Roundtable.pdf)

<sup>89</sup> See the comments of Mr. Donald Nicolaisen, Chief Accountant of the SEC, “Personally, I believe that no accounting firm should be in the business of selling these kinds of tax products [highly engineered tax products] to their audit clients.” (page 12); Mr. Elliot Schwartz, Council of Institutional Investors, “... we have established a very bright-line test, which is to say that, the appropriate non-audit services that an audit firm ought to provide are zero ...” (page 68). Mr. Michael Gannon, Pricewaterhouse Coopers (Risk Compliance), “Fundamentally, I believe our tax system is, if you will, an advocacy system. ... we would all prepare our returns in a manner that is consistent with the tax laws, but in a manner that would be designed to ... minimize our taxes. That’s the way the system works ...” (page 121-122). Mr. Elliot Schwartz from the Council of Institutional Investors, argued that, “audit firms should not be providing non-audit services to their audit clients.” (page 147) At [http://www.pcaobus.org/rules/2004-07-14\\_Roundtable\\_Transcript.pdf](http://www.pcaobus.org/rules/2004-07-14_Roundtable_Transcript.pdf)

<sup>90</sup> Mr. Scott Bayless from Deloitte & Touche argued that having the auditor provide tax services would “enhance audit quality” because tax issues cannot be “decided once a year, but involve continuous consultation as the company undertakes transactions and business events during the year.” (page 41); Mr. Michael Gannon from PricewaterhouseCoopers indicted that having the auditor provide tax services increases “transparency” and promotes “efficiency from the client’s point of view.” (page 47). Mr. Jim Brasher from KPMG added that there is an “advantage in using the auditor” to provide tax services, because the auditor “has to be approved by the audit committee.” (page 76) Mr. Tom Ochsenschlager from the AICPA extended this line of argument noting that there would be “four levels of review,” rather than just two, if the auditor performs tax services. (page 93) In the long run this would “save costs” and make it “much more likely that you would get appropriate tax advice.” (page 73-74). At [http://www.pcaobus.org/rules/2004-07-14\\_Roundtable\\_Transcript.pdf](http://www.pcaobus.org/rules/2004-07-14_Roundtable_Transcript.pdf)

<sup>91</sup> This conclusion was reached early in the discussions. See page 17. At: [http://www.pcaobus.org/rules/2004-07-14\\_Roundtable\\_Transcript.pdf](http://www.pcaobus.org/rules/2004-07-14_Roundtable_Transcript.pdf)



For its own part, the US has been critical of foreign principles-only standards. In particular, the US is critical of these regulations when they do not provide a sufficiently detailed structure, resulting in a standard that is not clearly operationalized. The SEC feels that principles-only-based rules depend too much on the exercise of individual judgment.

Like the UK, the US believes that more direction is needed. The rules need not be as restrictive as the French envision, but they need to be considerably more specific than the rules that have been advanced in the EU and Australian legislation. The US is no longer comfortable with the assumption of the Levitt regulations, an assumption that still underpins rules in the EU, Australian and elsewhere, that the tax authorities provide enough oversight of the auditor in tax matters so that security regulation can be relaxed.

In this context the PCAOB's project to draft tax service rules is very important. The PCAOB intends to draft rules that apply the basic principles of the Levitt reforms, within the conceptual framework established by Sarbanes-Oxley. The manner of this application is a classic example of objectives-oriented standard setting, and it signals a new direction for US rulemaking. If the PCAOB accomplishes its mission, and provides detailed rules for tax services without re-introducing bright-line tests, exceptions and limitations, then a significant step toward corporate governance convergence will have been taken. At least in the area of tax services, the US will be governed by an integrated, objectives-oriented set of coordinated standards, found in statutes, regulations and rulings that seek to assure auditor independence.

The foreign response to these efforts will be a measure of how far we have come toward convergence.