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Sarbanes-Oxley and the Provision of Non-Audit Transaction Tax Services: A Comparative Assessment of US, French, Australian and Japanese Rules

Richard T. Ainsworth*
Hiroki Akioka**

The Sarbanes-Oxley Act of 2002 is US legislation that mandates wide-ranging reforms in the public company financial reporting process. The central concern is with auditor independence. Similar legislation has been enacted in France, Australia and Japan.

This paper pays specific attention to the provision of non-audit transaction tax services by the auditor as an example of the US approach. The US approach is contrasted with that of France, Australia and Japan. France and Japan represent extreme positions.

The paper considers whether difference in approach to auditor independence will prompt US regulators to exercise extra-territorial regulatory powers over foreign accounting firms that audit firms listing on US exchanges.

Keywords : Auditor Independence; Transaction Taxes; Security Regulation; Corporate Governance.

The Sarbanes-Oxley Act of 2002 (P.L. 107-204, 116 Stat. 274.101) (SOX)[1] mandates wide-ranging reforms in the public company financial reporting process. Identifying trusted providers of essential tax services for global businesses is close to the heart of this legislation.[2]

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* Adjunct Professor in Taxation at Boston University School of Law (Former Deputy Director of the International Tax Program at Harvard Law School) [mailto: vatprof@bu.edu]
** Professor of Macroeconomics at Kansai University [mailto: hiroki_akioka@post.harvard.edu]

[1] Full text of the law is available at http://www.law.uc.edu/CCL/Soact/soact.pfd

[2] See for example: 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).

SOX is US legislation designed to restore confidence in the management of public companies following the post-Enron outcry over the accounting that shook investor confidence in the US securities market. The Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB)[3] are in the process of issuing regulations that flesh out the contours of this law.

SOX does not stand alone. Similar legislation has been enacted in France, Australia and Japan. Additional legislation is planned in each of the 25 countries of the European Union, after a proposed modification to the 8th Corporate Directive. In part, these countries are following a US lead, but they are also responding to their own domestic, Enron-like financial collapses. Australia witnessed the collapse of HIH (March, 2001)[4] and One.Tel (July, 2001).[5] In France there were serious corporate governance problems with Vivendi (July 2002), in the Netherlands there was the near bankruptcy of Ahold (February, 2003).[6] In Italy Parmalat (February, 2003) faced corporate fraud accusations and near collapse.[7] Only Japan, among the countries listed was spared the anxiety of a major corporation collapse due to accounting irregularities.

Without question, management practices within the world's largest corporations will be changing.[8] Just how it changes may depend on where business is conducted, which financial markets are accessed, and how effectively regulatory authorities achieve a global

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[3] The PCAOB was established under Title I of SOX. Its function is to monitor auditing, quality control, ethics, independence and other standards relating to the preparation of these reports. The PCAOB will conduct inspections, investigations and disciplinary proceedings. Section 106 (a) of SOX specifically extends the PCAOB's authority to non-US public accounting firms. On December 10, 2003 the PCAOB released for public comment proposed rules on oversight of non-US firms. (Release number 2003-024. Available at: www.pcaobus.org/pcaob_rulemaking.asp).

[4] 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.*

[5] 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.

[6] In Ahold earnings were overstated due to improper booking of supplier discounts.

[7] In Parmalat $3.5 billion in false assets were recorded in Caymen Island subsidiaries.

[8] See: Kim, Brian. *Recent Development: Sarbane-Oxley Act,* 40 Harvard Journal on Legislation 235 (Winter, 2003).

convergence of standards.[9]

This paper considers an area where there is considerable divergence of opinion, the provision of non-audit tax services by the auditor.[10] It finds that the French and the Japanese take polar opposite positions; the French prohibit all non-audit services (including tax services), where the Japanese generally permit non-audit tax services (unless they are expressly prohibited). The US[11] and Australian positions fall in between. The US relies on economic market forces and the judgment of the audit committee.[12] Australia relies on the ethical standards of the accounting profession and depends on the exercise of good judgment by the individual accountant in accordance with these rules.

In a concluding hypothetical this article will examine the allocation of audit, non-audit and prohibited services among competing

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[9] Considerable academic debate has focused on the global convergence of corporate governance practices. See for example: L. A. Bebchuck and M. J. Rowe, "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.

[10] The financial dynamics at the core of this problem was outlined and quantified by Senator Carl Levin (D-Michigan) on the floor of the US Senate. (148 Cong. Rec. S6563; daily edition, July 10, 2002). By 1999, 50% of revenues at the Big Five accounting firms came from consulting services, while only 34% came from auditing. By 2002, almost 75% of the fees earned came from non-audit, consulting services. The evidence indicated, according to Senator Levin, that the accounting firms were lowering their audit fees to secure lucrative consulting contracts.

[11] SOX treats taxation as a suspect advisory function. Of all the possible non-audit services that the auditor can be approved to offer to its client by the audit committee, only tax services must be separately itemized along with the fees paid for the advice. (See: 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); www.sec.gov/rules/final/33-8183.htm). The reason for this is most likely attributable to the fact that each of the highly publicized security scandals that have occurred over the past few years have involved either the tax positions taken by the companies or the determination of tax reserves. For example see: (1) Enron: 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; (2) Tyco: 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; (3) WorldCom: Carrie Johnson and Ben White, *WorlcCom Arrests Made: Two Former Executives Charged with Hiding Expenses,* Washington Post, August 2, 2002, at A-1.

[12] See: 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); www.sec.gov/rules/final/33-8183.htm

service providers as they would occur under the US rules.[13] The hypothetical will describe the analytical process that will most likely be followed by an audit committee (a) to approve the independent auditor and (b) to approve the performance of non-audit tax services by that same auditor.

This hypothetical argues that global businesses will respond to SOX by securing independent, third party providers of transaction tax services both in the US and abroad. Frequently selecting providers that are not affiliated with any of the major accounting firms. Additionally, depending on the current and expected reach of a firm's transactional business, providers will be preferred when they offer technology-intensive solutions that have deep internal control functionality, and that will expand globally with business opportunities. It is unlikely that the same allocation would be made under just the French, Australian or Japanese rules.

I. Scope and Motivation for Change: The Global Scope of US SOX Compared with the Domestic Scope of Other Legislation

SOX is global in scope.[14] The same is not the case with the French, Japanese and Australian rules. In these countries auditor independence is a concern of corporate law, not a rule regulating participants in the domestic securities markets.

United States

The US Congress was concerned with public confidence in US financial markets, and felt that this could not be restored if firms that listed shares maintained Enron-like relationships with public accounting firms outside the US. Thus, the US rules were drafted to

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[13] A conscious decision was made to craft a tax-based example that was isolated from the income tax. The great tax debate spawned by SOX concentrates in income taxes. This is not surprising given the financial size of the tax planning, tax shelter and transfer pricing consultancies they refer to. By placing this analysis in transaction taxes it is hoped that the decision process of the audit committee can be seen more clearly.

[14] See: Benov, Matthew M. *The Equivalence Test and Sarbanes-Oxley: Accommodating Foreign Private Issuers and Maintaining the Vitality of U.S. Markets,* 16 Transnational Lawyer 439 (Spring, 2003); Weiss, Harry J. *Impact of Sarbanes-Oxley Act on Non-U. S. Companies Whose Shares are Traded in the United States Markets,* 1336 Practicing Law Institute 303 (October 9, 2002); Taneda, Kenji. *Sarbanes-Oxley, Foreign Issuers and United States Securities Regulation,* 2003 Columbia Business Law Review 715; Stuart, David M. and harles F. Wright. *The Sarbanes-Oxley Act: Advancing the SEC's Ability to Obtain Foreign Audit Documentation in Accounting Fraud Investigations,* 2002 Columbia Business Law Review, 749.

impact both domestic and foreign issuers,[15] as well as domestic and foreign public accounting firms.[16]

Foreign accounting firms have protested, but to no avail. Some of the more vocal foreign accounting organizations have been the Institute of Chartered Accountants in England and Wales,[17] the Institut der Wirtschaftsprufer,[18] the Fédération des Experts Comptables Européens.[19] Fritz Bolkestein, the EU Financial Services Commissioner threatened retaliation and suggested that US firms may be required to submit to new regulatory controls in each of the EU countries, if EU firms are not exempted from US regulation.[20]

France

French auditor independence reforms are found in the *Loi de Sécurité Financière* that became law on July 17, 2003 (published August 2, 2003).[21] The seriousness of the French law can be gleaned from its enforcement provisions. Enforcement is through a new agency, the *Haut Conseil du Commissariat aux Comptes,* a component of the Ministry of Justice.

French law has long employed a principles-based approach to auditor regulation. The French National Institute External Auditors

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[15] For example, See: SOX section 302, which concerns quarterly "discloser controls and procedures" by CEO and CFO's. The SEC expressly extended this provision to foreign issuers and their CEO's and CFO's. (U.S. Securities and Exchange Commission, RIN 3235-AI54 "Certification of Disclosure in Companies' Quarterly and Annual Reports" (August 28, 2002, release date; August 29, 2003, effective date); www.sec.gov/rules/final/33-8124.htm). Similarly, SOX section 404, which concerns "internal controls over financial reporting" by CEO's and CFO's. It is also expressly extended to foreign issuers and their CEO's and CFO's by the SEC. (U.S. Securities and Exchange Commission, RIN 3235-AI66 "Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports" (June 5, 2003, release date; August 14, 2003, effective date); www.sec.gov/rules/final/33-8238.htm).

[16] SOX Section 106(a) subjects foreign accounting firms to the act, SOX section 104(a) requires the PCAOB to conduct a continuing program of inspections over all accounting firms that file reports with the Commission, and SOX 802 imposes penalties for violations. See: PCAOB Release number 2003-024. "Proposed Rule on Oversight on Non-U. S. Firms." (December 10, 2003) at www.pcaobus.org/pcaob_rulemaking.asp).

[17] See: Letters of Peter Wyman, President of the Institute of Chartered Accountants in England and Wales, to the SEC on December 24, 2002 at www.sec.gov/rules/proposed/s74902/pwyman1.htm and January 10, 2003 at www.sec.gov/rules/proposed/s74902/pwyman2.htm.

[18] See: Letter of Dr. Veidt and Professor Naumann, from the Institut der Wirtschaftsprüfer on December 27, 2002 at www.sec.gov/rules/proposed/s74902/veidt1.htm.

[19] See: Letters of David Devlin, President of the Fédération des Experts Comptables Européens to the SEC on January 13, 2003 at www.sec.gov/rules/proposed/s74902/ddevlin1.htm.

[20] *U.S. and E.U. Face Off Over Sarbanes-Oxley Regulation,* AccountingWEB.com (June 18, 2003) at www.accountingweb.com/cgi-bin/item.cgi?id=97712

[21] 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

(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.[22] A post-Enron study by AFEP-AGREF (Association Francaise des Entreprises Privées et Association des Grandes Enterprises Francaises: Association of French Private Sector Companies and Association of Major French Corporations) supported changes in French law, but not in its overall regulatory methodology.

However, when it comes to non-audit services and auditor independence, the French provide no margin for error. All non-audit services are prohibited. Thus the AFEP-AGREF states,"... 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."[23]

As a result there is no possibility that the auditor of a French firm that was listed on an American exchange would be of concern to the US under the auditor independence rules of SOX. Non-audit services, tax-related or otherwise, are simply not permitted.

Australia

Australia began a comprehensive corporate law economic reform program in 1997 (the CLERP initiative). The ninth package reforms in this initiative took up the issue of auditor independence, "Corporate Disclosure: Strengthening the Financial Reporting Framework." It 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,[24] 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.[25]

CLERP 9 is based on proposals for change from three sources: (1)

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[22] 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

[23] AFEP-AGREF, "Promoting Better Corporate Governance in Listed Companies," 23 September 2002. At: http://www.medef.fr/staging/medias/upload/367_FICHIER.pdf

[24] The complete legislations package can be found at http://www.treasury.gov.au/documents/700/PDF/CLERP_Bill.PDF

the Ramsay report *Independence of Australian Company Auditors* (October 2001),[26] (2) the Joint Committee on Public Accounts and Audits *Report 391: Review of Independent Auditing by Registered Company Auditors* (September 2002)[27] and (3) recommendations from the HIH Royal Commission.[28]

Australian reforms follow a principles-based methodology. This methodology was strongly supported by the Ramsay report, Report 391, and the HIH Royal Commission. The Institute of Chartered Accountants in Australia also lent its support. In a July 16, 2002 news release, "Australia Ahead of the Game," it favorable compared the Australian principles-based approach with the American rules-based methodology. It saw Sarbanes-Oxley as a movement by the US to come closer to the international norm. It was, "... the first steps towards convergence of US standards to the development of comprehensive international accounting standards."[29]

The Australian initiative applies International Accounting Standards through professional standards. Under this approach the Auditor must identify "threats" to independence and then "safeguards" to these threats. If the auditor determines that the "safeguards" are ineffective, the professional standard mandates prohibition.[30] Non-audit tax services are generally approved. They are not seen as a "threat" when provided by the auditor to the client.[31] (F.1; 2.77) (Guidance Notice Appendix 1 at 1-2.

It is very likely that the US would be concerned under the auditor independence rules of SOX, when an Australian auditor was provid-

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[25] 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

[26] The Ramsay Report can be found at http://www.treasury.gov.au/documents/183/PDF/ramsay.pdf

[27] See: http://www.aph.gov.au/house/committee/jpaa/indepaudit/reportscript.pdf

[28] HIH Royal Commission (Justice Neville Owen), *Report of the HIH Royal Commission,* 2003. At: http://hihroyalcom.gov.au/finalreport

[29] 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

[30] 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.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FEDE-E2901D78/cpa/hs.xsl/1018_9995_ENA_HTML.htm

[31] 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 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

ing non-audit tax services to a client that was listed on an American exchange. Where the Australian rules do not see a "threat," the US sees a suspect class.

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 waited even after learning of Enron, WorldCom, HIH, One.Tel, Vivendi, Ahold and Parmalat.

Japan responded, not to accounting failures but to the foreign regulatory reforms themselves, particularly those in the US. The defining event for Japanese regulators was section 106(a) of SOX. These are the extra-territorial enforcement provisions of the Act and through them the SEC and PCAOB are authorized to oversee foreign accounting firms.[32] When the PCAOB initiated rulemaking procedures[33] that would bring Japanese auditing firms under direct US oversight (in instances where Japanese firms were preparing financial statements for companies listed on American exchanges) Japan began to replace its peer review system with an independent regulatory structure.[34]

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.[35] Japan hopes that its reform and enforcement regime will sufficiently impress the SEC and the PCAOB that there will be no need to initiate enforcement actions in Japan.[36]

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[32] 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.

[33] 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.

[34] 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.

[35] 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.

Japan's reform has two aspects: (a) an amendment to 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) related Cabinet Office Ordinances (*Naikakufurei* 2004-4-1). In the law, promulgated June 6, 2003, a new government oversight and inspection agency, the CPA and Auditing Oversight Board (CPAAOB) was established. In Article 5 of the related Cabinet Ordinance, rules on auditor independence were published. These rules are a literal translation of the statutorily prohibited non-audit services in section 201(a)(1)-(8) of SOX.

Because non-audit tax services are not prohibited under SOX, the effect of the Japanese Ordinance is to permit the auditor to perform these services, and to do so without engaging in the kind of economic and financial market-place analysis that SOX requires the audit committee to engage in. This is the area of greatest concern for Japanese observers, and will be of considerable concern to the PCAOB as it looks at Japanese auditors of Japanese firms listing on American exchanges.

This concern is set out by Professor Kenjiro Egashira, professor of corporate law at the University of Tokyo.[37] He points out that the business manager of a Japanese company must get pre-approval of the audit committee and the shareholders before he can appoint, dismiss or reappoint an auditor.[38] However, once approved, the business manager does not need to get audit committee approval when he determines the extent of the non-audit services the auditor will be asked to perform. Nothing in the "Certified Public Accountant Law" (*Kouninkaikeishihou* 1948-8-1); "An Act to Amend Part of the Certified Public Accounting Law" (*Kouninkaikeishihou no ichibu wo kaisei suru houritsu* 2004-4-1), or the related Cabinet Office Ordinances (*Naikakufurei* 2004-4-1) changes this.

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[36] Naohiko Matsuo indicated, "We respectfully request that the [US] PCAOB rely on the [Japanese] CPAAOB to the maximum extent, and not to conduct on-site inspections and on-site investigations of the Japanese audit firms." See item 6 in the zip file associated with "Rulemaking Docket Matter 013" at: http://www.pcaobus.org/rulemaking_docket.asp

[37] Kenjiro Egashira, *Kouninkaikeishi kansa seido no kaikaku to kongo no kadai (The Reform of the CPA Audit System in Japan and Coming Problems)*, Accounting, April 2003. (In Japanese).

[38] See: The Special Law of the Commercial Code, *Shouhou Tokureihou (1974)*.

Summary of the Auditor Independence Regimes

	US	EU	France	Australia	Japan
Basic Principles Govern Specific Rules (commonly): No role in management Not auditing one's own work No client advocacy function	Yes: Principles govern standards set in law, regulation and rulings.	Yes: International Accounting Standards advocated.	No: All non-audit services are prohibited	Yes: International Accounting Standards applied through Professional Standards	Yes: International Accounting Standards
Identified Non-audit services Bookkeeping IT design/ implementtion Valuation Actuarial Internal audit Management Broker/ dealer Legal advocacy	Prohibited	Professional Standards based on "basic principles" applied. Auditor must identify "threats" to independence and "safeguards." Ineffective "safeguards" mandates prohibition	Prohibited	Professional Standards based on International Accounting Standards. Auditor must identify "threats" to independence and "safeguards." Ineffective "safeguards" mandates prohibition (F.1; 2.54 - 2.101)	Prohibited
Tax services	1. Prohibited if an "Identified" Non-audit service 2. Audit committee approval or non-approval	Generally approved, unless determined to be a "threat."	Prohibited	Generally approved. Not seen as a "threat." (F.1; 2.77) (Guidance Notice Appendix 1 at 1-2.	Allowed
Inspection & Enforcement	PCAOB -- Private-sector, non-profit corporation, under SEC.	Self-enforcement through professional standards	Ministry of Justice Agency: Haut Conseil du Commissariat aux Comptes	Inspection by Financial Reporting Council (government); Enforcement by ASIC (Australian Securities and Investments Commission - "for profit" corp.)	CPAAOB - agency of government: Financial Services Admin.

II. An Understanding of Sarbanes-Oxley

The extra-territorial scope of SOX, compounded by differences in the way various countries view auditor independence makes it important to understand how the US analyzes problems in this area. In the following sections this paper will (a) set out the operative assumptions that underlie SOX, (b) explain the economic basis for the law and related regulations, and (c) outline the audit committee's dynamic decision-making.

The paper continues with (d) a detailed consideration of the essential distinctions between audit, prohibited, and non-audit services as set out in the law and SEC regulation, and (e) an example that demonstrates how an audit committee should consider who should provide non-audit transaction tax services.

(a) The Operative Assumptions of Sarbanes-Oxley

The operative assumptions underlying SOX are fundamentally economic not legal in nature. Congress perceived Enron's problem to be one of the market place. Independent auditors were taking unfair advantage of their positions to dominate the provision of financial advisory serves to audit clients. The effort to maximize profits compromised objectivity and the independence of the auditor.

Senator Sarbanes spelled out standards during Senate floor debates.[39] The SEC discussed these "simple principles" in the final regulations. The SEC stated:

... 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.[40]

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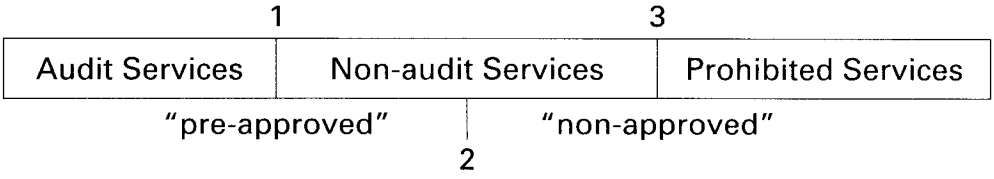
[39] Senate Report 107-205, 107th Cong., 2d Sess., July 3, 2002),

[40] SEC release no. 33-8183. "Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence," effective May 6, 2003; www.sec.gov/rules/final/33-8183.htm

Using these principles, SOX divides the financial services into three categories: audit, non-audit and prohibited services. Graphically, the three service categories can be represented as follows, with an additional distinction of "pre-approved" and "non-approved" services placed below them. There are three decision points: (1) between audit and non-audit services, (2) between pre-approved and non-approved non-audit services, and (3) between non-audit services and prohibited services. Different distinctions are made at each of these points, and the analysis required to make them is not the same.



Simply stated, SOX requires all audit services to be pre-approved by the audit committee, as well as some of the non-audit services.[41] Likewise, all prohibited services are off limits for the firm's auditor, as are the remaining unapproved non-audit services.

(b) The Economic Approach to Regulation in Sarbanes-Oxley

SOX, the SEC and the PCAOB have provided reasonably clear tests at the extremes. The PCAOB has defined an audit (decision point 1), and the SEC has defined the parameters of prohibited services (decision point 3) very clearly. If there is ambiguity, it is in the large grey area between these distinctions – the area of non-audit services. In this area the audit committee must make its SOX decisions without the assistance of bright line tests.[42] These decisions are market place driven, a methodology far more compatible than bright line rules are with traditional US securities regulation.[43] SOX

[41] Section 202 of SOX. "[T]he audit committee [must] pre-approve the services – both audit and permitted non-audit – of the accounting firm." U.S. Securities and Exchange Commission, RIN 3235-AI73, "Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence" (January 28, 2003, release date; May 6, 2003, effective date) at II (D); www.sec.gov/rules/final/33-8183.htm).

is market enabling legislation.

It should be anticipated that there will be a conservative application of the rules at decision points 1 and 2. That is, when faced with a difficult decision between audit and non-audit services, most audit committees will "play it safe," place the service in the non-audit category, and let the market place decide who should perform the service.[44] Similarly, when faced with a difficult distinction between prohibited and non-audit services, most audit committees will again "play it safe" and place the service in the prohibited category, off limits to the auditor.[45] Non-audit services then, will become the focal point of most SOX decisions, and decisions here will be based on considerations of "efficiencies and investor protection."

The reason for this conservatism is the expansion of crimes, penalties and civil liability in the law. There are seven new crimes: (1) an expansion of the definition of securities fraud;[46] (2) changes to and expansion of obstruction of justice in areas of document destruction,[47] (3) tampering,[48] or (4) inducing others to do the

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[42] Some critics have argued for bright line tests in this area. The SEC has considered these arguments and has decided to move in a different direction. See: Durst, Michael C. & Thomas H. Gibson. "Audit" vs. Non-Audit" Tax Services under Sarbanes-Oxley. The Tax Executive (November-December, 2003) 474-477. See also the letter of Robert T. Bossart, retired Tax Partner from Arthur Andersen, to the SEC on January 2, 2003 at www.sec.gov/rules/proposed/s74902/rtbossart1.htm; and the letter of Philip A. Laskewy, retired chairman of Ernst & Young to the SEC who asks for "absolute clarity as to which non-audit services are probited, and which are permitted subject to audit committee pre-approval." www.sec.gov/rules/proposed/s74902/palaskawy1.htm

[43] The letter of the ABA Sarbanes-Oxley Task Force to the SEC on January 6, 2003 argues against a "blanket exemption of tax services from prohibitions of the Act," but also argues that "a simple requirement of audit committee pre-approval of tax services would [not] provide sufficient protection to the investing public." Thus, the ABA requests that the SEC "identify in advance the types of tax services that involve a sufficient risk to auditor independence under the three basic principles, and to subject the audit firm and the registrant to sanctions of the Act if any are performed by the audit firm." This is what the SEC has done through its market-approach to determining "approved" non-audit services in the final regulations. The ABA's letter can be found at www.sec.gov/rules/proposed/s74902/hnbeller1.htm;

[44] If a company incorrectly classifies a service performed by the auditor as an "audit" service, when in fact the service was a "non-audit" tax service, then the company may be found to have failed in its pre-approval obligations, and misrepresented its fees for non-audit tax services. Although a violation of SOX, and thereby a violation of the Security Exchange Act of 1934 under section 3 of SOX, there is a de minimus exception under section 202 which also amends the 1934 Act under section 10A. The exception allows up to a 5% error rate based on total revenues paid to the auditor in a year.

[45] An auditor performing a prohibited service has no benefit of a de minimus rule. The violation of SOX is immediate. Section 3 of SOX makes this a violation of the Securities Exchange Act of 1934. Penalties apply for the auditor, the company, and the CEO and CFO, if they have certified SEC reports containing the violation.

[46] SOX section 807. And under section 803 debts are not dischargeable under the bankruptcy laws if they are incurred in violation of security fraud provisions.

[47] SOX section 802.

same;[49] (5) retaliation against informants and whistleblowers is a crime;[50] (6) attempts and conspiracies to commit these crimes are themselves a crime;[51] (7) false certification under sections 302 and 404 has been criminalized.[52]

New penalties are created, and others have been expanded. The penalties are directed at both individuals and companies. For example, if financial statements need to be restated due to material non-compliance with SOX, senior management may have to return bonuses.[53] Provisions require the disgorgement of funds.[54] Violators can be barred from future public company service.[55] Fines have been increased,[56] sentences increased,[57] and the statute mandates changes to sentencing guidelines.[58]

Section 3 of SOX will have a significant effect on increasing civil liability. Simply stating that any violation of SOX is also a violation of the Securities Exchange Act of 1934,[59] this provision opens the door for shareholder suits under section 10b-5. Thus any assertion of material misrepresentation will be underscored with an assertion that the company failed to have an adequate disclosure control system in place.

(c) The Dynamic Decision-making Process of the Audit Committee Under Sarbanes-Oxley

The analysis proposed in this paper is dynamic. Its vision is that the audit committee will use competing centers of professional expertise to make a market-place allocation of "non-audit" tax services among competing service providers. There are at least three centers of professional tax expertise involved: the auditor, third

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[48] SOX section 802.
[49] SOX section 1102.
[50] SOX section 1107 and 806
[51] SOX section 902.
[52] SOX section 906. A knowing violation of the certification provisions carries up to a $1,000,000 fine, 10 years imprisonment, or both. Willful violations carry up to a $5,000,000 fine, 20 years imprisonment, or both.
[53] SOX section 304.
[54] SOX section 308.
[55] SOX section 1105.
[56] SOX section 804.
[57] SOX section 1106.
[58] SOX section 1106.
[59] Securities Exchange Act of 1934, 15 U.S.C. Sections 78 et seq.

party service providers, and the tax department of the firm.

The audit committee's first responsibility is to tentatively determine the auditor.

The second item on the audit committee's agenda is to become extremely familiar with all third party providers of "prohibited" services. There are two reasons for this. First, the audit committee needs assurance that the auditor is neither directly involved in the provision of these services, nor is it indirectly involved with a third party providers in a way that the independence of its audit opinion would be compromised. Secondly, this group of service providers, along with the auditor and the tax department, will populate the competitive market place that the audit committee will use to make case-by-case allocations of non-audit services.

The final item on the audit committee's agenda is to confirm the auditor, and to separately itemize each of the non-audit tax services it has decided to "approve" for the auditor to perform. No audit committee "approval," and no itemization is required for services to be performed by someone other than the auditor.

(d) Audit, Prohibited, and Non-Audit Services Under Sarbanes-Oxley

The critical terms in this analysis are polar opposites: audit services and prohibited services. Everything else falls in between.

The First Pole: Audit Service
SOX, SEC and PCAOB Rules

What is an audit? Section 2(a)(2) of SOX provides:

"The term 'audit' means an examination of the financial statements of any issuer by an independent public accounting firm in accordance with the rules of the Board or the Commission (or, for the period preceding the adoption of applicable rules of the Board under section 103, in accordance with the then-applicable generally accepted auditing and related standards for such purposes), for the purpose of expressing an opinion on such statements."

Admittedly, the statutory definition lacks detail. However, it does point to where details can be found -- in "the rules of the Board or the Commission." The Board is the PCAOB, established under Title I of SOX, and the Commission is the SEC.

The SEC considered this issue briefly in two recent regulations.[60] In the discussion of the final regulations on "Standards Relating to Listed Company Audit Committees" the SEC was asked for further clarification of "audit, review or attestation services." The SEC explained:

"[T]his category includes services that normally would be provided by the accountant in connection with statutory and regulatory filings and engagements. In addition to services necessary to perform an audit or review in accordance with Generally Accepted Auditing Standards ('GAAS') this category may also include services that generally only the independent accountant can normally provide, such as comfort letters, statutory audits, attest services, consents and assistance with and review of documents filed with the Commission."[61]

In this discussion the SEC referred the reader to the Commission's discussion of "audit fees" in regulations issued earlier that same year.[62] The SEC stated that, "... 'audit, review or attest' services ... [are] the same services covered in the 'Audit Fees' category in an issuer's disclosure of fees paid to its independent public accountants."[63] Those regulations stated:

"Audit Fees, [are] the aggregate fees billed for each of the last two fiscal years for professional services rendered by the principal accountant for the audit of the registrant's annual financial statements and review of financial statements including the registrant's Form 10-Q (17 CFR 249.308a) or 10-QSB (17 CFR 249.308b) or services that are normally provided by the accountant in connection with

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[60] Brevity does not seem to indicate lack of interest on the part of the SEC, but rather reflects an SEC policy decision that a detailed definition on the scope of an audit may in the first instance belong to the PCAOB. Pursuant to Section 107 of SOX, proposed rules of the PCAOB do not take effect unless approved by the SEC. After approval the standards established by the PCAOB are deemed to be rules under SOX.

[61] U.S. Securities and Exchange Commission, RIN 3235-AI75, "Final Rule: Standards Relating to Listed Company Audit Committees" (April 9, 2003 release date; April 25, 2003, effective date) at Section II(B)(1). Also: 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 II(D); www.sec.gov/rules/final/33-8183.htm).

[62] UU.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); www.sec.gov/rules/final/33-8183.htm).

[63] U.S. Securities and Exchange Commission, RIN 3235-AI75, "Final Rule: Standards Relating to Listed Company Audit Committees" (April 9, 2003 release date; April 25, 2003, effective date) at Section II(B)(1); www.sec.gov/rules/final/33-8220.htm).

statutory and regulatory filings or engagements for those fiscal years."[64]

Further details were made public on October 7, 2003. At that time the PCAOB issued a proposed auditing standard defining an audit.[65] The level of detail provided by the PCAOB is extensive. The standard itself is 63 pages in length, and is followed by five appendixes of illustrative reports that consume another 47 pages.

The PCAOB follows the SEC in adopting a "broader" definition of "audit" than is provided in GAAS. The lines are clear. The PCAOB refers consistently to "an integrated audit of the financial statements and internal control over financial reporting," for which it adopts the short hand expression "audit of internal control over financial reporting."[66] The PCAOB summary of this definition is:

"An audit of internal control over financial reporting is an extensive process involving several steps. It is integrated with the audit of the financial statements. Under the proposed auditing standard, these steps would include: planning the audit; evaluating the process management used to perform its assessment of internal control effectiveness; obtaining an understanding of the internal control; evaluating the effectiveness of both the design and operation of the internal control; and forming an opinion about whether internal control over financial reporting is effective."[67]

Audit and Non-audit Tax Services

The SEC anticipates that there will be tax services provided on both sides of the audit/ non-audit services line (decision point 1 in the diagram above). Tax services that are considered to be part of the audit function were illustrated as follows:

"For example, in some situations, a tax partner may be involved

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[64] 17 CFR 240.14a-101, Item 9 (e)(1). See also: 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); www.sec.gov/rules/final/33-8183.htm).

[65] PCAOB Release number 2003-017. "Proposed Auditing Standard – An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements." (October 7, 2003); www.pcaobus.org/pcaob_rulemaking.asp).

[66] PCAOB Release number 2003-017. "Proposed Auditing Standard – An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements." (October 7, 2003) at pages A-8 through A-10; www.pcaobus.org/pcaob_rulemaking.asp).

[67] PCAOB Release number 2003-017. "Proposed Auditing Standard – An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements." (October 7, 2003) at page 6; www.pcaobus.org/pcaob_rulemaking.asp).

in reviewing the tax accrual that appears in the company's financial statements. Since that is a necessary part of the audit process, that activity constitutes an audit service. ... the activity constitutes an audit service since it is a necessary procedure used by the accountant in reaching an opinion on the financial statements."[68]

Tax services may also fall on the other side of the audit/ non-audit service line (decision point 1 in the diagram above). If these tax services are "pre-approved" by the audit committee for the auditor to perform, the fees associated with them must be itemized and disclosed [17 CFR Part 240.14a-101, Item 9(e)(3)]. The SEC provides an extensive list of types of "non-audit" tax services in the following:

"The tax fees category would capture all services performed by professional staff in the independent accountant's tax division except those services related to the audit as discussed previously. Typically, it would include fees for tax compliance, tax planning, and tax advice. Tax compliance generally involves preparation of original and amended returns, claims for refund and tax-payment planning services. Tax planning and tax advice encompass a diverse range of services, including assistance with tax audits and appeals, tax advice related to mergers and acquisitions, employee benefit plans and requests for rulings or technical advice from taxing authorities."[69]

This list does not, of course, indicate whether these "non-audit" tax services should be "pre-approved" by the audit committee for the auditor to perform. That decision is based on considerations of "efficiency and investor protection." In terms of the above diagram, that is a decision point 2 issue. If however, the audit committee decides not to "pre-approve" these "non-audit" services, the SEC neither requires fee disclosure, nor does it require that the specific services be itemized in periodic reports filed with it.

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[68] 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) II (D); www.sec.gov/rules/final/33-8183.htm).

[69] 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) II (H); www.sec.gov/rules/final/33-8183.htm).

The Second Pole: Prohibited Services SOX, and SEC Rules

Unlike the definition of audit service, prohibited services are more clearly spelled out both in SOX and in SEC rules. Section 201(a) of SOX adds the to section 10A of the SEC Act of 1934 the following language.

> [I]t shall be unlawful for a registered public accounting firm ... that performs for any issuer any audit required by this title ... to provide to that issuer, contemporaneously with the audit, any non-audit service, including --
>
> (1) bookkeeping or other services related to the accounting records or financial statements of the audit client;
> (2) financial information systems design and implementation;
> (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
> (4) actuarial services;
> (5) internal audit outsourcing services;
> (6) management functions or human resources;
> (7) broker or dealer, investment adviser, or investment banking services;
> (8) legal services and expert services unrelated to the audit; and
> (9) any other service that the Board determines, by regulation, is impermissible.
>
> ... A registered public accounting firm may engage in any non-audit services, including tax services, that is not described in any of the paragraphs (1) through (9) for an audit client, **only if** the activity is approved in advance by the audit committee of the issuer, ..." (emphasis added).

Statute and regulations both anticipate that tax services will straddle the line between prohibited services and non-audit services (decision point 3 in the diagram above). The closing language in the above passage from SOX provides the test for determining which side of the non-audit/ prohibited services line a tax service fall on.

Test by Analogy

Although drafted with an affirmative tone, "... a registered public

accounting firm may engage in any non-audit services, including tax services, ..." SOX places a very clear qualification on the provision of tax services by the auditor. The tax services must not be "...described in any of the paragraphs (1) through (9) for an audit client..." Thus, we determine if tax services are prohibited services by analogous reasoning.

If "bookkeeping or other services related to the accounting records or financial statements of the audit client" is prohibited; so too would be "bookkeeping related to tax records." Both are closely related to the accounting records or financial statements of the audit client. If, "financial information systems design and implementation" is prohibited; so too would the "design or implementation" of a tax-based "financial information system." If "internal audit outsourcing services" are prohibited; so too would the "internal audit" of tax services be prohibited. If "management functions" are prohibited; so too is tax management functions, an area that includes many of the tax planning decisions made in a firm. And finally, if "legal services and expert services unrelated to the audit" are prohibited; so too are tax legal services, or tax expert services.

The SEC demonstrates the application of this test a number of times. One time an analogy is drawn back to the "broker-dealer" prohibition in item (7).[70] Another time the SEC reasons analogously from the legal services prohibition in item (8). In the later instance the SEC states:

> [M]erely labeling a service as a 'tax service' will not necessarily eliminate its potential to impair independence under Rule 2-01(b). Audit committees and accountants should understand that providing certain tax services to an audit client would, as described below, or could, in certain circumstances, impair the independence of the accountant. Specifically, accountants would impair their independence by representing an audit client before tax court, district court or federal court of claims.[71]

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[70] 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 note 111; www.sec.gov/rules/final/33-8183.htm).

(e) Example:

The Analytical Process of the Audit Committee in Determining Who Should Provide Non-Audit Transaction Tax Services?

The Company

X Corporation is a Fortune 500, domestic or foreign, publicly held multinational corporation listed on the New York Stock Exchange, subject to the Securities Exchange Act of 1934 and the Sarbanes-Oxley Act of 2002. X Corporation, or its wholly owned subsidiaries have sales in all 50 states as well as 80 countries around the world. X Corporation is subject to sales and use taxes in over 7,000 domestic taxing jurisdictions, as well as VATs in most foreign jurisdictions. Gross sales exceed $25 billion. Domestic Sales and Use taxes range between 5 – 10%, the VATs range between 15 – 20%.

The CEO of X Corporation has decided that the size of the company's global transaction tax obligations require that stronger internal controls over financial reporting be put in place in light of section 302 of SOX, which requires quarterly evaluation by the CEO of internal controls, and section 404's annual certification of the effectiveness of those internal controls. Although transaction taxes had not previously been a major concern, final SEC regulations emphasizing that financial control over cash flow was as important as financial control over profit and/ or loss made this move necessary.[72] Transaction tax cash flows exceed $3 billion annually, a material amount, and something that the CEO is now directly concerned with.

The Transaction Tax Service Providers

Assume that there are only four accounting firms large enough to provide global auditing services to X Corporations (CPA-1, CPA-2, CPA-3 and CPA-4). CPA-1 is tentatively selected as the independent auditor for X Corporation (pending audit committee approval). A

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[71] 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 II (B)(10). www.sec.gov/rules/final/33-8183.htm).

[72] U.S. Securities and Exchange Commission, RIN 33-8124: "Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports," (August 29, 2002, effective date) at www.sec.gov/rules/final/33-8124.htm).

final decision is waiting on decisions by X Corporation with respect to certain transaction tax services that CPA-1 is also offering to perform.

Five firms are offering comprehensive, technology intensive software packages that determine transaction tax obligations worldwide. Two of the four CPA firms (CPA-1 and CPA-2) offer these packages, as well as three independent third party software providers (Software-1, Software-2, and Software-3).

Content. The tax calculation technology of all five providers is similar. CPA-1, CPA-2, and Software-1 have done all their own tax research. The VAT portion of Software-2's tax research is out sourced to CPA-1. The VAT research of Software-3 is outsourced to an international law firm.

Seven Additional Services Offered by Transaction Tax Providers

1. *Installation and integration services.* CPA-1, CPA-2, CPA-3, and CPA-4 provide installation and integration services for all transaction tax software packages. Software-1 provides this service only for its own software product.

2. *Mapping services.* All service providers (CPA-1, CPA-2, CPA-3, CPA-4, Software-1, Software-2 and Software-3) provide mapping services whereby company product codes are "mapped" or associated with product codes in transaction tax software packages. Each CPA firm offers this service to clients regardless of the software installed. The service offered by each of the Software firms applies only for their own product.

3. *Transaction tax return preparation/ reporting services.* CPA-1, CPA-2 and Software-1 also offer return preparation services. CPA-1 and Software-1 have fully automated return services that tie directly to their tax calculation programs. Portions of CPA-2's return service is performed manually. CPA-3 and CPA-4 offer these services manually. Neither Software-2, nor Software-3 offer return preparation services.

4. *Government transaction tax audit/ compliance services.* CPA-1, CPA-2, CPA-3, and CPA-4 provide global audit support services. They assist companies with government audit investigations, and provide expert services as needed globally. Software-1 provides

these services on a limited basis, commonly in a remote capacity.

5. *Transaction tax litigation and advocacy services.* CPA-1, CPA-2, CPA-3, CPA-4, and global law firms provide litigation support and tax advocacy services globally. No Software company offers this service either domestically or overseas.

6. *Transaction tax planning services.* CPA-1, CPA-2, CPA-3, CPA-4, Software-1, and Software-3 provide global transaction tax planning services including such things as nexus determinations, registration requirements under special taxing regimes, and VAT-based cash flow assessments.

7. *Historical transaction tax assessment services.* Each firm with transaction tax software offers a service that checks historical transaction tax records against the tax rates in effect at the time. The service is used to identify errors (underpayments or overpayments due to calculation, nexus errors or other problems).

Audit Committee Decision #1:
Determining the Auditor—No Prohibited Services

CPA-1 has been proposed as the auditor, and the audit committee has tentatively approved the audit engagement, subject to a determination of which transaction tax software package the CEO will install, and the manner in which the installation is to take place.

Critical issues revolve around whether or not CPA-1 would be directly or indirectly engaged in providing prohibited services under SOX section 201(a) through its involvement with the transaction tax software program. If the CEO decides to install CPA-1's transaction tax software, CPA-1 cannot be approved as the auditor. There are several reasons for this.

(a) The audit file within the software package records the tax attributes of all company transactions. Data is used both for return filing purposes and is entered into the general ledger. This is a prohibited bookkeeping function under SOX section 201(a)(1). The data within the audit file is, "related to the accounting records or financial statements of the audit client."

(b) Because CPA-1 designed its own transaction tax system, using this system within the company would also preclude

CPA-1 from being approved for the audit engagement. SOX section 201(a)(2) lists the design of a "financial information system" as a prohibited service.

(c) If CPA-1 were to perform the installation and integration of its own system, this would provide additional grounds for disqualifying CPA-1 as the auditor under SOX section 201(a)(2).

(d) Because transaction tax software systems perform internal control functions, the use of CPA-1's transaction tax software in the company would be an additional barrier to CPA-1 being approved as the independent auditor under SOX section 201(a)(5) which restricts the auditor from performing "internal audit functions."

If the CEO decides instead to install the transaction tax software package of Software-2 there may be an indirect conflict. Software-2 has embedded within its code the tax research decisions of CPA-1. If CPA-1 were the independent auditor for X Corporation it would be auditing its own work.

CPA-1 would be participating in many of the same prohibited functions it would if its own software had been installed. CPA-1 was involved in the "design" of the VAT portion of Software-2's financial information software. The software is performing "internal audit functions." The violation of section 201(a) would be most apparent if CPA-1 were providing continuous updates of VAT law changes for the Software-2 system during the audit engagement period. However, the historical research embedded in the Software-2's code may be just as damaging, although not as immediately apparent.

Thus, if CPA-1 is to be approved as the auditor, CPA-1 must stand clear of all prohibited services. This necessarily limits the field of software providers to CPA-2, Software-1 and Software-3.

Selecting the Transaction Tax Software Provider

In this situation, the CEO's best choice for a transaction tax software provider is Software-1. The two primary reasons are: (1) that Software-1 does its own tax research, a point that was discussed above, and (2) that Software-1 will install and integrate its own system.

Integration decisions will remain with X Corporation until the transaction tax software is removed. Selecting CPA-2, CPA-3, or CPA-4 for installation and integration services will limit the company's choice of future auditors. To avoid having one of the large auditing firms eliminated from future consideration as a potential auditor, X Corporation should not use any of the large accounting firms to install and integrate their transaction tax software.

The remainder of this discussion assumes: (1) that CPA-1 is approved by the audit committee as the auditor, (2) that Software-1's transaction tax software is purchased, and (3) that Software-1 performs the installation and integration of the software.

Audit Committee Decision #2:
Determining which Non-Audit Services Could Be "Approved" for the Auditor, CPA-1, to Perform

Because CPA-1 is the auditor, if it is also approved to perform any non-audit tax services, X Corporation must separately list the service and the fee in its financial statements. Each time the audit committee decides to approve CPA-1 to perform a particular service, it is obligated to review similar offers made by other providers. "Efficiency and investor protection" are the weights it will place in the balance.

These are market-place decisions. There should be at least three categories of "players" in a healthy market: the auditor (CPA-1), the tax department of X Corporation, and the other third-party transaction tax service providers (CPA-2, CPA-3, CPA-4, Software-1, Software-2 and Software-3).

Mapping services. This activity relies on detailed knowledge of two data bases, X Company's product skew codes, and Software-1's product codes. None of the players would appear to have detailed knowledge of both. X Company's tax department would have exceptional knowledge of the product skew codes, and Software-1 would have detailed knowledge of the product codes used in its own software. Thus, it is likely that one or both of these players will perform this function. CPA-1 would not be pre-approved to perform this service.

Return preparation/ reporting services. Monitoring the return

preparation function is critical when trying to establish internal control over transaction tax flows, amounts that range from 5 to 20% of gross sales. Software-1's tax calculation engine determines and then stores in an audit file a record of all the transaction taxes collected by X Company. Additional software offered by Software-1 takes this data and populates state, local and city sales and use tax returns, as well as VAT returns globally. In addition VIES and Intrastat reports are prepared for filing in the European Union.

Even though each of the other service providers offer similar tax return/ reporting services, Software-1's fully automated system gives greatest internal control. Investor confidence would be stronger and economic efficiencies realized if Software-1's product is used. The manual return system offered by CPA-3 and CPA-4 will have more errors, and the paper files will be more difficult to locate if they are needed at a later date. The automated systems of CPA-1 and CPA-2 may be just as accurate as Software-1's, but they will most likely not perform as seamlessly as would Software-1's product.

Government audit/ compliance services. Only the four CPA firms offer global assistance to help X Company resolve government compliance audits. Software-1 offers limited services in this regard. CPA-1 may offer significant efficiencies over all competitors. They are in a unique position as X Corporation's auditor, and are fully knowledgeable of the global corporate structure and tax position of X Corporation.

It may be however, that X Company will decide to use different CPA firms in different parts of the globe, based on a determination of the strengths of local practices.

Transaction tax litigation and advocacy services. Again, only the four CPA firms, and large law firms offer these services globally. However advocacy is a prohibited activity for the auditor (SOX Section 201(a)(8)). Thus, the audit committee cannot approve this service for CPA-1. X Corporation should select among the other players.

One of the advantages of using a global law firm for this service would be the flexibility this would give X Corporation should it decide to change auditors. For example, it would be difficult to

select CPA-2 as the next auditor, if the legal department of CPA-2 was providing ongoing advocacy service for X Corporation. This might put X Corporation in the uncomfortable position of either selecting an auditor that was not its first choice, or interrupting the tax advocacy function being provided by CPA-2 before it was concluded.

Transaction tax planning services. Each of the CPA firms as well as Software-1 and Software-3 offer global transaction tax planning services. If this service were to be performed by CPA-1, there is a strong possibility that CPA-1 would be auditing its own work, or acting in a management position in violation of section 201(a). Investor confidence might be negatively effected.

Because tax planning decisions have long-term impact on a firm, X Corporation might view it to be unwise to use any of the CPA firms in this capacity, as it might limit its options on who it could engage as the auditor in the future.

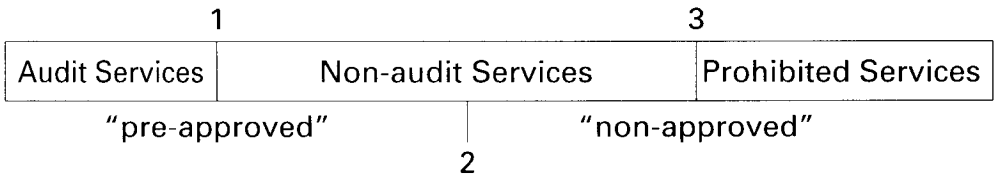
Software-1 or Software-3 might be reasonable options, however greatest efficiency and investor confidence would probably result from retaining a large law firm, probably the same firm that was engaged to perform litigation and advocacy functions.

Summary: Allocation Across Providers

	CPA-1	CPA-2	CPA-3	CPA-4	Soft-1	Soft-2	Soft-3	Tax Dept.	Law
Audit	X *								
Transaction Tax Software					X				
Installation, integration					X				
Mapping					X			X	
Return Preparation					X			X	
Government audit/ compliance	X *	X	X	X					
Litigation & advocacy									X
Tax planning									X
Historical assessment service	X *								

* Audit committee pre-approval required.

Summary: Allocation based on Decision Points



Audit	Approved Non-audit services	Non-approved Non-audit services	Prohibited Services
CPA-1: Audit			Software-1: Transaction Tax Software Software-1: Installation & Integration
		Software-1 or Tax Department: Mapping Software-1 or Tax Department: Return Preparation	
	CPA-1: Government audit compliance	CPA-2; CPA-3; CPA-3: Government audit compliance	
		Law: Tax Planning	Law: Litigation and advocacy
CPA-1: Historical assessment service			

Conclusion

Applying SOX to the provision of tax services by the auditor is a complex undertaking. There are three distinct decision points. Distinctions must be drawn between (1) audit and non-audit services, (2) pre-approved and non-approved non-audit services, and (3) non-audit services and prohibited services. The standards to be applied by the audit committee in each of these instances are very different.

To distinguish between audit tax services and non-audit tax services, the audit committee should ask: Is the service, "... a necessary procedure used by the accountant in reaching an opinion on the financial statements?" Or is it "...a necessary procedure used by the accountant in reaching an opinion on the internal controls over financial reporting?" In all cases reference should be made to the PCAOB's "Proposed Auditing Standard – An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements."

The standard to apply when distinguishing between non-audit tax services and prohibited tax services is very different. In this instance the audit committee needs to reason by analogy to the eight specifically prohibited services listed in section 201(a) of SOX. Care should be taken however, as the list may be expanded by the PCAOB. The ninth item in section 201(a) is: "...any other service that the Board determines, by regulation, is impermissible."[73]

In the great grey area between audit and prohibited services, the audit committee is faced with a different decision, and yet another standard. The determination of whether or not a particular "non-audit" tax service should be "pre-approved" for performance by the auditor is determined on an assessment of "efficiencies and investor protection." This is an economic standard, and needs a competitive market place of competing service providers to be applied. Application of the economic standard is best demonstrated by example.

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[73] There are indications that the PCAOB may move to extend the list of prohibited serves, particularly in the area of tax services. See the comments of the acting chairman of the PCAOB, Charles Niemeir to the London Financial Times. Andrew Parker and Adrian Michaels, "US Accounts Watchdog Threatens Crackdown," (April 16, 2003).

This is not the way auditor independence issues are resolved in other jurisdictions. The cases of France, Australia and Japan have been considered. Among the other countries France and Japan represent extreme positions, with the French prohibiting non-audit tax services absolutely, and the Japanese not considering them at all.

A survey of recent filings of annual reports (Form 20-F) for 2003 with the SEC by all French and Japanese companies shows this difference. SOX will require all foreign firms to disclose the amounts that companies paid to their auditors in four categories (audit; audit related; non-audit tax, and other non-audit services) by 2005. Many firms are providing this information early, on a voluntary basis, or because foreign laws already require the disclosure.

In the case of French firms the *Loi de Sécurité Financière* already requires disclosure. In the case of Japanese firms there is nothing in the "Certified Public Accountant Law" (*Kouninkaikeishihou* 1948-8-1); "An Act to Amend Part of the Certified Public Accounting Law" (*Kouninkaikeishihou no ichibu wo kaisei suru houritsu* 2004-4-1), or the related Cabinet Office Ordinances (*Naikakufurei* 2004-4-1) that requires this kind of disclosure. As a result, only 8 of the 23 Japanese firms filing Form 20-F disclose this break-down of fees, whereas all 18 of the French firms do.

In the category of non-audit tax services, the filings indicate that Japanese firms paid 12% more to their auditors in 2003 than they did in 2002, whereas the French firms paid 23% less for non-audit tax services by their auditors. The difference seems to be attributable the difference in French and Japanese law, and not SOX, which will not apply until annual reports are filed in 2005. It will be interesting to re-examine this difference at that time, when all of the Japanese firms will be required to disclose the amount of non-audit tax fees paid to their auditor.

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