

rules are predicated on the three basic principles enumerated earlier. One of those principles is that an auditor cannot audit his or her own work and maintain his or her independence. When an accounting firm provides bookkeeping services for an audit client, the firm may be put in the position of later auditing the accounting firm's own work. If, during an audit, an accountant must audit the bookkeeping work performed by his or her accounting firm, it is questionable that the accountant could, or that a reasonable investor would believe that the accountant could, remain objective and impartial. If the accountant found an error in the bookkeeping, the accountant could well be under pressure not to raise the issue with the client if raising the issue could jeopardize the firm's contract with the client for bookkeeping services or result in heightened litigation risk for the firm. In addition, keeping the books is a management function, which also is prohibited.⁵⁰

Accordingly, we are adopting rules stating that all bookkeeping services would cause the auditor to lack independence unless it is reasonable to conclude that the results will not be subject to audit procedures. We proposed to prohibit bookkeeping services unless it was "reasonably likely that such services would not be subject to audit procedures." Our final rules make clear the presumption to emphasize the responsibility the accounting firm has in making a determination that the bookkeeping services will not be subject to audit procedures.

The rules utilize the previous definition of bookkeeping or other services, which focuses on the provision of services involving: (1) Maintaining or preparing the audit client's accounting records, (2) preparing financial statements that are filed with the Commission or the information that forms the basis of financial statements filed with the Commission, or (3) preparing or originating source data underlying the audit client's financial statements. Our experience with this definition demonstrates that the concept of bookkeeping and other services is well understood in practice.

We understand that accountants sometimes are asked to prepare statutory financial statements for foreign companies, and these are not filed with us. Consistent with the Commission's previous rules, an accountant's

independence would be impaired where the accountant prepared the statutory financial statements if those statements form the basis of the financial statements that are filed with us. Under these circumstances, an accountant or accounting firm who has prepared the statutory financial statements of an audit client is put in the position of auditing its own work when auditing the resultant U.S. GAAP financial statements.

With respect to the prohibitions on (1) bookkeeping; (2) financial information systems design and implementation; (3) appraisal, valuation, fairness opinions, or contribution-in-kind reports; (4) actuarial; and (5) internal audit outsourcing, the rules state that the service may not be provided "unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements."⁵¹ As proposed, for bookkeeping, appraisal or valuation, and actuarial services, the provision was "where it is reasonably likely that the results of these services will be subject to audit procedures during an audit of the audit client's financial statements" while for the other two services, there was no such wording. We have added the new wording to all five services to provide consistency in application. Additionally, the change from "reasonably likely * * *" to "unless it is reasonable to conclude" is intended to narrow the circumstances in which that condition can be invoked to justify the provision of such services.⁵²

2. Financial Information Systems Design and Implementation

Currently, Paragraph (c)(4)(ii) identifies certain information technology services that, if provided to an audit client, impair the accountant's independence. The proposed rules identified information technology services that would impair the auditor's independence. Under Paragraph (c)(4)(ii)(A) of the proposed rule, an accountant would not be independent if the accountant directly or indirectly operates or supervises the operation of the audit client's information system or manages the audit client's local area network or information system. Further, Paragraph (c)(4)(ii)(B) of the proposed

rule provided that an accountant is *not* deemed independent if the accountant designs or implements a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements taken as a whole. These services were deemed to impair an accountant's independence under our previous rules.

Some commenters⁵³ suggested that the Commission's rules should include a dollar threshold limit or other qualifying language. Others⁵⁴ suggested that the Commission should clarify that the prohibition on designing and implementing systems would include selecting and testing a client's financial information system. Commenters⁵⁵ also believe that the Commission should clarify that recommendations for improvements in the systems should be permitted.

The Commission is adopting rules, consistent with our previous rules, that prohibited the accounting firm from providing any service related to the audit client's information system, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. These rules do not preclude an accounting firm from working on hardware or software systems that are unrelated to the audit client's financial statements or accounting records as long as those services are pre-approved by the audit committee.

As noted above, the rule prohibits the accountant from designing or implementing a hardware or software system that aggregates source data or generates information that is "significant" to the financial statements taken as a whole. In this context, information would be "significant" if it is reasonably likely to be material to the financial statements of the audit client. Since materiality determinations may not be complete before financial statements are generated, the audit client and accounting firm by necessity will need to evaluate the general nature of the information as well as system output during the period of the audit engagement. An accountant, for

⁵³ See, e.g., letter from Radin, Glass & Co., dated December 31, 2002; letter from Institute of Chartered Accountants in England & Wales, dated December 24, 2002; letter from Deloitte & Touche LLP, dated January 10, 2003.

⁵⁴ See, e.g., letter from HarborView Partners LLC, dated December 4, 2002; letter from California Public Employees' Retirement System, dated January 10, 2003; letter from Center for Investor Trust, dated January 13, 2003.

⁵⁵ See, e.g., letter from Sullivan & Cromwell LLP, dated January 10, 2003.

⁵⁰ Letter of Samuel L. Burke, Associate Chief Accountant, SEC, to Florida Institute of Certified Public Accountants re: bookkeeping (March 4, 2002).

⁵¹ An example of a situation where it would be reasonable to conclude that the results would not be subject to audit procedures would be where an accounting firm provides a prohibited service to an affiliate of the client, as defined in Rule 2-01(f)(4), but the accounting firm is not the auditor of the entity or entities that controls the accounting firm's audit client or its affiliate.

⁵² As such, there is a rebuttable presumption that the services are subject to audit procedures.