

these services will be subject to audit procedures during an audit of the audit client's financial statements because providing these services may cause an accountant later to audit his or her own work. Additionally, accountants providing these services assume a key management task. In addition, actuarially-oriented advisory services may affect amounts reflected in some company's financial statements.

Some commenters<sup>65</sup> agreed with our proposed prohibition of actuarial services. Others,<sup>66</sup> however, believe that some types of actuarial services should be permitted.

Consistent with our proposal, we continue to believe that when the accountant provides actuarial services for the client, he or she is placed in a position of auditing his or her own work. Accordingly, the rules we are adopting prohibit an accountant from providing to an audit client any actuarially-oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts for the audit client other than assisting a client in understanding the methods, models, assumptions, and inputs used in computing an amount, 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.

As can be seen, however, we believe that it is appropriate to advise the client on the appropriate actuarial methods and assumptions that will be used in the actuarial valuations. It is not appropriate for the accountant to provide the actuarial valuations for the audit client.

The rules also provide that the accountant may utilize his or her own actuaries to assist in conducting the audit provided the audit client uses its own actuaries or third-party actuaries to provide management with its actuarial capabilities.

## 5. Internal Audit Outsourcing

Our previous rules on internal audit outsourcing allowed a company to outsource part of its internal audit function to the independent audit firm subject to certain exemptions. For example, smaller businesses were exempt from the internal audit outsourcing prohibition because there

had been concerns about the potentially disproportionate impact on such companies.

Some companies "outsource" internal audit functions by contracting with an outside source to perform, among other things, all or part of their audits of internal controls. As emphasized by the Committee of Sponsoring Organizations ("COSO"), internal auditors play an important role in evaluating and monitoring a company's internal control system.<sup>67</sup> As a result, some argue that internal auditors are, in effect, part of a company's system of internal accounting control.<sup>68</sup>

Since the external auditor typically will rely, at least to some extent, on the existence of an internal audit function and consider its impact on the internal control system when conducting the audit of the financial statements,<sup>69</sup> the accountant may be placed in the position of auditing his or her firm as part of the internal control system. In other words, if the internal audit function is outsourced to an accountant, the accountant assumes a management responsibility and becomes part of the company's control system. Our proposed rule provided that an accountant is not independent when the accountant performs internal audit services related to the internal accounting controls, financial systems, or financial statements, for an audit client.

Some commenters<sup>70</sup> agreed with the proposed rule. While some commenters<sup>71</sup> believed that our rule should contain exemptions for smaller companies, others<sup>72</sup> did not. Some commenters<sup>73</sup> believed that the final rule should include a "reasonably likely to be subject to audit procedures" provision similar to other prohibited services (e.g., bookkeeping). Still other

commenters<sup>74</sup> suggested that the Commission should clarify that services provided in conjunction with an audit or attest service are permissible.

The rules we are adopting prohibit the accountant from providing to the audit client internal audit outsourcing services. This prohibition would include any internal audit service that has been outsourced by the audit client that relates to the audit client's internal accounting controls, financial systems, or financial statements 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.

During the conduct of the audit in accordance with generally accepted auditing standards ("GAAS") or when providing attest services related to internal controls, the auditor evaluates the company's internal controls and, as a result, may make recommendations for improvements to the controls. Doing so is a part of the accountant's responsibilities under GAAS or applicable attestation standards and, therefore, does not constitute an internal audit outsourcing engagement.

Along those lines, this prohibition on "outsourcing" does not preclude engaging the accountant to perform nonrecurring evaluations of discrete items or other programs that are not in substance the outsourcing of the internal audit function. For example, the company may engage the accountant, subject to the audit committee pre-approval requirements, to conduct "agreed-upon procedures" engagements<sup>75</sup> related to the company's internal controls, since management takes responsibility for the scope and assertions in those engagements. The prohibition also does not preclude the accountant from performing operational internal audits unrelated to the internal accounting controls, financial systems, or financial statements.

## 6. Management Functions

In our proposal, we did not propose any significant change to our previous rule on management functions. Some commenters<sup>76</sup> suggested that we clarify

<sup>67</sup> See, Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control—Integrated Framework*, at 7 (1992) (the "COSO Report").

<sup>68</sup> See, SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements," AU § 322.

<sup>69</sup> SAS No. 55, "Consideration of Internal Control in a Financial Audit," AU § 319.

<sup>70</sup> See, e.g., letter from Perry Adkins, dated December 24, 2002; letter from The Center for Investor Trust, dated January 13, 2003.

<sup>71</sup> See, e.g., letter from James L. Crites, dated December 28, 2002; letter from Cranmore, FitzGerald & Meaney, dated December 27, 2002; letter from America's Community Bankers, dated January 13, 2003; letter from Dixon Odom LLC, dated December 20, 2002.

<sup>72</sup> See, e.g., letter from California Public Employees' Retirement System, dated January 10, 2003; letter from Institute of Internal Auditors, dated January 13, 2003.

<sup>73</sup> See, e.g., letter from Deloitte & Touche, dated January 10, 2003; letter from Ernst & Young LLP, dated January 6, 2003.

<sup>74</sup> See, e.g., letter from Hansen, Barnett & Maxwell, dated January 13, 2003; letter from Deloitte & Touche LLP, dated January 10, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003; letter from American Institute of Certified Public Accountants, dated January 9, 2003.

<sup>75</sup> See, AT § 201, "Agreed-Upon Procedures."

<sup>76</sup> See, e.g., letter from American Institute of Certified Public Accountants, dated January 9, 2003; letter from Grant Thornton, LLP dated January 13, 2003; letter from Sullivan & Cromwell LLP, dated January 10, 2003; letter from Computer Sciences Corporation, dated January 13, 2003.

<sup>65</sup> See, e.g., letter from California Public Employees' Retirement System, dated January 10, 2003; letter from Aon Consulting, dated January 13, 2003.

<sup>66</sup> See, e.g., letter from PricewaterhouseCoopers, dated January 8, 2003; letter from Deloitte & Touche LLP, dated January 10, 2003; letter from General Electric Company, dated January 9, 2003.