

that evaluations of and recommendations for improvements in a company's systems or controls does not constitute a management function.

Consistent with our proposal, the final rules prohibit the accountant from acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client.

We believe, however, that services in connection with the assessment of internal accounting and risk management controls, as well as providing recommendations for improvements, do not impair an accountant's independence.

Accountants must gain an understanding of their audit clients' systems of internal controls when conducting an audit in accordance with GAAS.⁷⁷ With this insight, accountants often become involved in diagnosing, assessing, and recommending to audit committees and management ways in which their audit client's internal controls can be improved or strengthened.⁷⁸ The resulting improvements in the audit client's controls not only result in improved financial reporting to investors but also can facilitate the performance of high quality audits. For these reasons, we are continuing to allow accountants to assess the effectiveness of an audit client's internal controls and to recommend improvements in the design and implementation of internal controls and risk management controls.

As discussed in the previous section on financial information systems design and implementation, when an accountant designs and implements its audit client's internal accounting and risk management control systems, some believe that the accountant will lack objectivity if called upon to audit financial statements that are derived, at least in part, from data from those systems or to report on those controls or on management's assessment of those controls. As such, we believe that designing and implementing internal accounting and risk management controls is fundamentally different from obtaining an understanding of the controls and testing the operation of the controls which is an integral part of any

audit of the financial statements of a company. Likewise, design and implementation of these controls involves decision-making and, therefore, is different from recommending improvements in the internal accounting and risk management controls of an audit client (which is permissible, if pre-approved by the audit committee).

For example, management could engage a third-party service provider to design and implement an inventory control system. In the course of that engagement, the third-party service provider might ask the accountant to make recommendations on internal control and accounting system components that have been included in the system being designed. Providing such recommendations to the third-party service provider would not place the independent accountant in the role of management.

Because of this fundamental difference, we believe that designing and implementing internal accounting and risk management controls impairs the accountant's independence because it places the accountant in the role of management. Conversely, obtaining an understanding of, assessing effectiveness of, and recommending improvements to the internal accounting and risk management controls is fundamental to the audit process and does not impair the accountant's independence. Furthermore, the accountant may be engaged by the company, subject to the audit committee pre-approval requirements, to conduct an agreed-upon procedures engagement⁷⁹ related to the company's internal controls or to provide attest services related to the company's internal controls without impairing his or her independence.

7. Human Resources

Our previous rules deem an accountant to lack independence when performing certain human resources functions, and we did not propose any significant change to those rules. Many commenters⁸⁰ agreed that the accountant should be prohibited from providing certain human resources functions for audit clients.

Consistent with our proposal, these rules provide that an accountant's independence is impaired with respect to an audit client when the accountant searches for or seeks out prospective candidates for managerial, executive or

director positions; acts as negotiator on the audit client's behalf, such as determining position, status, compensation, fringe benefits, or other conditions of employment; or undertakes reference checks of prospective candidates. Under the rule, an accountant's independence also is impaired when the accountant engages in psychological testing, or other formal testing or evaluation programs, or recommends or advises the audit client to hire a specific candidate for a specific job.

Assisting management in human resource selection or development places the accountant in the position of having an interest in the success of the employees that the accountant has selected, tested, or evaluated. Accordingly, observers may perceive that an accountant would be reluctant to suggest the possibility that those employees failed to perform their jobs appropriately, or at least reasonable investors might perceive the accountant to be reluctant, because doing so would require the accountant to acknowledge shortcomings in its human resource service. The accountant also might have other incentives not to report such employees' ineffectiveness, including that the accountant would identify and be identified with the recruited employees.

8. Broker-Dealer, Investment Adviser or Investment Banking Services

Our previous rules deem an accountant to lack independence when performing brokerage or investment advising services for an audit client.⁸¹ We are adopting rules that add serving as an unregistered broker-dealer⁸² to

⁸¹ These rules are not meant to change the Commission's previous position that an audit firm's broker-dealer division can cover an industry (including industry surveys and analyses) which includes an audit client when performing analyst functions. However, analysis of a specific audit client's stock places the auditor in the position of acting as an advocate for the client and would cause the auditor to lack independence.

⁸² Accountants and the companies that retain them should recognize that the key determination required here is a functional one (*i.e.*, Is the accounting firm or its employee acting as a broker-dealer?). The failure to register as a broker-dealer does not necessarily mean that the accounting firm is not a broker-dealer. In relevant part, the statutory definition of "broker" captures persons "engaged in the business of effecting transactions in securities for the account of others." Securities Exchange Act of 1934 3(a)(4). Unregistered persons who provide services related to mergers and acquisitions or other securities-related transactions should limit their activities so they remain outside of that statutory definition. A person may "effect transactions," among other ways, by assisting an issuer to structure prospective securities transactions, by helping an issuer to identify potential purchasers of securities, or by soliciting securities transactions. A person may be "engaged in the business," among

⁷⁷ AU § 319, "Consideration of Internal Control in a Financial Statement Audit." In addition, Section 404(b) of the Act requires a company's audit to attest to the internal control report provided annually by management.

⁷⁸ AU § 325, "Communication of Internal Control Related Matters Noted in an Audit," requires the auditor to communicate reportable conditions and material weaknesses in internal control to the company's audit committee or equivalent.

⁷⁹ See, AT § 201, "Agreed-Upon Procedures."

⁸⁰ See, *e.g.*, letter from California Public Employees' Retirement System, dated January 10, 2003; letter from Aon Consulting, dated January 13, 2003.