

STATE OF MINNESOTA
BOARD OF ACCOUNTANCY

In the Matter of
Ernst & Young LLP
Permit No. 00941

STIPULATION AND
CONSENT ORDER
Board File 2009-020

It is hereby stipulated and agreed by Ernst & Young LLP ("Respondent"), 220 S Sixth Street, Suite 1400, Minneapolis, Minnesota 55402, and the Complaint Committee ("Committee") of the Board of Accountancy ("Board") that without trial or adjudication of any issue of fact or law and without any evidence or admission by any party with respect to any such issue:

1. A Notice of Conference with the Board of Accountancy's Complaint committee was duly served upon Respondent, receipt of which is hereby acknowledged by Respondent.

2. On June 26, 2009, Respondent represented by William Michael, Dorsey & Whitney LLP and Thomas Riesenber, Ernst & Young LLP, Deputy General Counsel, appeared before the Board's Complaint Committee, composed of Board members Michael M. Vekich, Chair, Neil Lapidus and Robert J. Hyde to discuss allegations made in the notice referenced above. Executive Director, Doreen Frost was also present. Gregory P. Huwe, Assistant Attorney General, represented the Board at the conference.

3. For the purpose of this stipulation, Respondent waives all procedures and proceedings before the Board to which Respondent may be entitled under the United States and Minnesota constitutions, statutes, or the rules of the Board, including the right to dispute the allegations against Respondent and to dispute the appropriateness of discipline in a contested case hearing pursuant to Minnesota Statute § 14 (2008). Respondent agrees that upon the ex parte application of the Committee, the Board may order the remedy specified in paragraph nine below. Respondent waives the right to any judicial review of the order by appeal, by writ of certiorari, or otherwise.

4. This Stipulation shall constitute the entire record of the proceedings herein upon which the Consent Order is based. All documents in the Board's files shall maintain the data

classification to which they are entitled under the Minnesota Government Data Practices Act, Minnesota Statute § 13 (2008). They shall not; to the extent they are not already public documents, become public merely because they are referenced herein.

5. In the event the Board in its discretion does not approve this Stipulation or a lesser remedy than specified in this Consent Order, this Stipulation and Consent Order shall be null and void and shall not be used for any purpose by either party. If this Stipulation is not approved and a contested case hearing is initiated by the Committee pursuant to Minnesota Statute § 14 (2008), Respondent agrees not to object to the Board's initiation of the hearing and it hearing the case on the basis that the Board has become disqualified because of to its review and consideration of this Stipulation or of any records relating hereto.

FACTS

6. Respondent admits the facts referred to below and grants that the Board may, for the purpose of reviewing the record in paragraph two above, consider the following as true without prejudice to the Respondent in any current or future proceeding of the Board with regard to these or other allegations:

a. The Securities and Exchange Commission found that Respondent engaged in improper professional conduct pursuant to Exchange Act Section 4C and Rule 102(e) of the Commission's Rules of Practice and on August 5, 2008, issued an ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 4C AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER, which is attached to this Order. The Securities and Exchange Commission Order describes a violation of the auditor independence rules with respect to a company, which has been identified as a corporation headquartered in Minnesota.

b. Respondent committed acts resulting in Respondent's sanctions imposed by the Securities and Exchange Commission, a federal government agency.

- c. Respondent violated Minnesota Statute § 326A.08, Subd 5(a) (7) (2008).

STATUTES

7. Respondent admits that the facts and conduct specified in paragraph six above constitutes violation of Minnesota Statute § 326A (2008) and Minnesota Rules chapter 1105 (2007), are sufficient grounds for the remedy specified in paragraph nine below, and that proof at hearing of any one or more of the allegations set forth would empower the Board to take disciplinary action against Respondent's permit.

8. This Stipulation shall not in any way or manner limit or affect the authority of the Board to proceed against Respondent by initiating a contested case hearing or by other appropriate means on the basis of any act, conduct, or admission of Respondent justifying disciplinary action which occurred before or after the date of this stipulation and that is not directly related to the specific facts and circumstances set forth herein.

REMEDY

9. Upon this Stipulation and record, as set forth in paragraph four above, and without any further notice of proceedings, the Committee and Respondent agree that the Board may, in its discretion, issue an order to Respondent requiring compliance with the following:

- a. Respondent's permit is **CENSURED** and **REPRIMANDED**.
- b. Concurrent with the submission of this Stipulation and Consent Order to the Board for its approval Respondent shall pay a **CIVIL PENALTY** of \$2,000.00

10. In accordance with Minnesota Statute § 16D.17 (2008), in the event this order becomes final and Respondent does not comply with the condition in paragraph 9(b) above, Respondent agrees that the Board may file and enforce the unpaid portion of the civil penalty as a judgment with out further notice or additional proceedings.

11. Violations of this Stipulation and Consent Order shall be considered a violation of Minnesota Statute § 326A.08, subd 5 (1) (2008). If Respondent violates this Stipulation and Consent Order, Minnesota Statute §§ 326A.01-.14 (2008) or Minnesota Rules 1105 (2007), the Board may impose additional discipline pursuant to the following procedure:

a. The Complaint Committee shall schedule a hearing before the Board. At least ten days prior to the hearing, the Committee shall mail Respondent a notice of the violation alleged by the Committee and of the time and place of the hearing. Service of notice on Respondent is complete upon mailing the notice to Respondent's last known address. Within seven days after the notice is mailed, Respondent shall submit a response to the allegations. If Respondent does not submit a timely response to the Board, the allegations may be deemed admitted.

b. At the hearing before the Board, the Committee and Respondent may submit affidavits made on personal knowledge and argument based on the record in support of their positions. The evidentiary record before the Board shall be limited to such affidavits and this Stipulation and Consent Order. Respondent waives a hearing before an administrative law judge and waives discovery, cross-examination of adverse witnesses, and other procedures governing administrative hearings or civil trials.

c. At the hearing, the Board will determine whether to impose additional disciplinary action, which may include additional conditions or limitations on Respondent's practice or suspension or revocation of Respondent's permit.

The Committee shall have the right to attempt to resolve an alleged violation of the Stipulation and Consent Order through the procedures of Minnesota Statute § 214.10 (2008). Nothing herein shall limit (a) the Committee's right to initiate a proceeding against Respondent pursuant to Minnesota Statute § 14 (2008), or (b) the Committee's and the Board's right to temporarily suspend Respondent's permit pursuant to Minnesota Statute § 326A.08, subd. 6 (2008), based on

a violation of this Stipulation and Consent Order or based on conduct of Respondent before or after the date of this stipulation which is not specifically referred to in paragraph 6 above.

12. Any appropriate court may, upon application of the Board, enter its decree enforcing the order of the Board.

13. Respondent hereby acknowledges that he has read, understands, and agrees to this Stipulation and Consent Order and has freely and voluntarily signed the stipulation without threat or promise by the Board or any of its members, employees, or agents. When signing the stipulation, Respondent acknowledges that he is fully aware that the Stipulation and Consent Order must be approved by the Board. The Board may approve the Stipulation and Consent Order as proposed, approve the order subject to specified change, or reject it. If the changes are unacceptable to Respondent or the Board rejects the stipulation, it will be of no effect except as specified herein.

14. This Stipulation and Consent Order is public data pursuant to Minnesota Statute § 13.41, subd. 4 (2008).

15. This Stipulation contains the entire agreement between the parties. Respondent is not relying on any other agreement or representation of any kind, verbal or otherwise.

16. If approved by the Board, a copy of this Stipulation and Consent Order shall be served personally or by first class mail on Respondent. The Order shall be effective and deemed issued when it is signed.

CONSENT:

BOARD OF ACCOUNTANCY
COMPLAINT COMMITTEE

DL Riederberg
Ernst & Young LLP Deputy General
Respondent Counsel

Dated: Feb. 15, 2010

Michael M. Vekich
MICHAEL M. VEKICH, CPA
Chair

Dated: 3/23, 2010

William Michael Jr.
WILLIAM MICHAEL JR.
Attorney

Dated: Feb 17, 2010

Gregory P. Huwe
GREGORY P. HUWE
Assistant Attorney General

Dated: 3/23, 2010

ORDER:

Upon consideration of the foregoing stipulation and based upon all the files, records and proceedings, herein,

1. IT IS HEREBY ORDERED that Respondent's certified public accountant permit is CENSURED AND REPRIMANDED, and
2. IT IS FURTHER ORDERED that all other terms of this stipulation and consent Order are adopted and implemented this 15 day of April, 2010.

STATE OF MINNESOTA
BOARD OF ACCOUNTANCY

Neil N. Lapidus
NEIL N. LAPIDUS, CPA
Chair

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58309 / August 5, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2858 / August 5, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13114 / August 5, 2008

In the Matter of

**ERNST & YOUNG LLP,
JOHN F. FERRARO, CPA, and
MICHAEL G. LUTZE, CPA,**

Respondents.

**ORDER INSTITUTING ADMINISTRATIVE
AND CEASE-AND-DESIST PROCEEDINGS
PURSUANT TO SECTIONS 4C AND 21C
OF THE SECURITIES EXCHANGE ACT
OF 1934 AND RULE 102(e) OF THE
COMMISSION'S RULES OF PRACTICE,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-
AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), and Rule 102(e)(1)(ii) of the Commission's Rules of Practice, against Ernst & Young LLP ("E&Y") and John F. Ferraro, CPA ("Ferraro"), and pursuant to Exchange Act Section 4C and Rule 102(e)(1)(ii) of the Commission's Rules of Practice against Michael G. Lutze, CPA ("Lutze") (collectively "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement ("Offers"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds¹ that:

A. Overview

This matter arises from an independence-impairing business relationship between E&Y and Mark C. Thompson, while Thompson was a member of the board of directors of three of its audit clients. The E&Y/Thompson relationship involved their collaboration in creating a series of audio CDs called *The Ernst & Young Thought Leaders Series*. The relationship spanned 19 months—October 2002 through early May 2004—during the entirety of which Thompson served as a director of E&Y audit client Company A, and during parts of which Thompson also served (i) as a member of Company A's Audit Committee; and (ii) as a director of two other E&Y audit clients: Company B and Company C. As detailed below, through their acts and omissions in this matter, all three Respondents engaged in improper professional conduct; Respondents E&Y and Ferraro were each a cause of certain issuer-reporting violations; and E&Y also violated, and Ferraro was a cause of E&Y's violations of, Rule 2-02(b) of Regulation S-X.

B. Respondents

Ernst & Young LLP ("E&Y") is a professional services firm, headquartered in New York City, with offices located throughout the United States. At all relevant times and continuing to the present, E&Y has provided auditing, consulting, and tax services to a variety of companies, including companies whose securities are registered with the Commission and trade in the U.S. markets.

John F. Ferraro, CPA, a resident of Magnolia, Massachusetts, has been a CPA for over twenty-seven years; he has been licensed as a CPA by the state of Wisconsin since May 1980. He currently also has an active license in Ohio, and inactive or expired licenses in New York, Illinois, Kansas and Missouri. Ferraro was at all relevant times an E&Y partner and Vice-Chairman of the firm whose title was Americas Vice-Chair of Markets, with oversight responsibility for the firm's sales organization. Ferraro first joined the firm in 1977, and by October 2002 had at least 19 years of public-company audit experience. He has not practiced as an auditor for at least the last five years.

Michael G. Lutze, CPA, a resident of Brookfield, Wisconsin, has been a licensed CPA for over twenty-four years; he has been licensed as a CPA by the state of Wisconsin since January 1984. He currently also has active licenses in Illinois, Minnesota and Pennsylvania, and an expired license in Maine. Lutze was at all relevant times an E&Y audit partner. Lutze became the coordinating partner on E&Y's Company A audit engagement in April 2003 and served in that role until May 2005.

¹ The findings herein are made pursuant to Respondents' Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

C. Relevant Issuers

At all relevant times, Company A's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange, and its fiscal year has ended on the last day of February. E&Y served as Company A's auditor from August 1994 until May 2005.

At all relevant times, Company B's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange, and its fiscal year has ended on the last day of April. E&Y has served as Company B's auditor since April 2002.

At all relevant times, Company C's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act and traded on the NASDAQ National Market, and its fiscal year has ended on the last day of December. E&Y served as Company C's auditor from May 2002 until May 2007.

D. The Director

Mark C. Thompson served on Company A's board from March 2000 through May 4, 2004, and on its Audit Committee from March 2000 until August 2003. Thompson served on Company B's board from March 2000 until September 10, 2003; and on Company C's board from February 26, 2004 until May 10, 2004. As a board member of these issuers, Thompson participated in annual board votes concerning E&Y's retention as auditor; these included votes on the inclusion of recommendations to retain E&Y in annual proxy solicitations to shareholders. Thompson also signed Forms 10-K filed with the Commission by Company A and Company B containing statements that each issuer's auditor was independent. As a member of Company A's Audit Committee, Thompson shared direct responsibility, under Company A's Audit Committee Charter, "for the appointment ... compensation and oversight ... of the [company's] independent auditor." See Appendix A to Company A's May 20, 2003 proxy statement.

E. FACTS

1. Establishment and Operation of the Relationship

In October 2002, at a time when Thompson was serving on the boards of two E&Y public company audit clients—Company A and Company B—and while Thompson was also serving on Company A's audit committee, E&Y entered into the business relationship with Thompson that is the subject of this proceeding. At the time, Thompson had recently completed a two-year project involving the production of eight CDs of prominent-leader interviews for his first customer for such an effort and wished to continue working on similar ventures. For its part, E&Y had recently established what it termed an "industry sector focus" approach to business development, which aimed to build its partners' expertise as "thought leaders" within particular industries and industry sectors.

During this period Respondent Ferraro was serving as the firm's Vice-Chair for Markets. In early October 2002, at the suggestion of an E&Y sales partner, Ferraro met with Thompson. Shortly thereafter, Thompson furnished a plan for a "pilot program" of four audio CDs to be called the "*E&Y Thought Leaders Series*." In this plan, Thompson proposed creating CDs of interviews of industry CEOs, with each CD featuring a particular industry or industry sector. According to Thompson's proposal, he would appear as host on the CDs; E&Y partners would also appear on the CDs and would—with Thompson's coaching and assistance—conduct the interviews of the industry leaders. In this way, Thompson proposed to "build the confidence and visibility" of E&Y "subject matter experts" and to promote them "as Thought Leaders in interviews that give [them] *a seat at the table* with CEOs and CFOs to discuss critical leadership issues in key industry sectors." (Italics in original.)

Ferraro agreed to Thompson's proposal and, when the two met again later that month, signed a one-page contract, thereby launching the venture. This initial contract was for \$104,000. Ferraro knew, at the time he signed the initial contract, that Thompson was a director of Company A and Company B, and that both companies were E&Y audit clients. Notwithstanding this knowledge, Ferraro failed to seek, or perform, or otherwise obtain any auditor-independence assessment prior to executing the contract. Ferraro had only limited involvement with the matter thereafter, because he asked one of his direct reports to implement the pilot series. On June 4, 2003, upon the pilot series' completion, Ferraro's direct report signed a second, more detailed agreement with Thompson to produce additional CDs over a two-year period for a fee of \$270,000 per year, with an option to cancel after one year.

In its operation, the relationship proceeded in accordance with Thompson's proposal, and the resulting CDs were provided to prospective E&Y audit and non-audit clients for business development purposes. During the course of the venture, memoranda were circulated within the firm characterizing the project as "Business Development Support for [E&Y's] Industry Sector Leaders" with "every potential to define [E&Y] as the number one provider" and "obviously great business development for E&Y's [audit and non-audit] strategies." The venture's business-development aims embraced not only the CDs' distribution, but also their creation; as one internal memorandum noted: "Since the CEO [interviewee] and the [E&Y] Partner actually sit at the table together, the opportunity to discuss business and make a 'sales call' with the decision maker is obviously much more direct than with distributing traditional brochures. For example, after we completed the interview with [one public company CEO] we were immediately able to set up meetings for anticipated projects valued at \$500,000. That's just one of the nine CEO meetings so far."

Each CD's packaging included both E&Y's and Thompson's proprietary logos and website addresses. Each CD's packaging also listed the name, title and contact information for E&Y personnel within the relevant industry or industry sector. Each CD included language recommending the services of E&Y and also endorsing a CD product line of Thompson; and each CD contained statements reflecting that it was the product of collaboration between Thompson and E&Y. Both Thompson and the E&Y personnel working on the project routinely addressed one another as members of a team; in one such message, an E&Y sales partner thanked Thompson for his "commitment to helping us win." During the course of the relationship, E&Y and Thompson produced a total of seven completed CDs, in five separate audiobooks; and E&Y paid Thompson

compensation totaling \$377,500—a sum comprising, unbeknownst to E&Y, approximately half of Thompson’s net income at the time.

2. E&Y Claimed Independence From Company A, Company B and Company C

Notwithstanding the fact that its business relationship with Thompson proceeded contemporaneously with either periods covered by its audits of companies on whose boards Thompson sat, or periods during which the work on those audits was performed, or both, E&Y claimed to be independent in its audit reports for Company A’s 2002 through 2004 fiscal years, Company B’s 2003 and 2004 fiscal years, and Company C’s 2004 fiscal year.² With E&Y’s knowledge and consent, those audit reports were, in turn, included, or incorporated by reference, in their clients’ annual reports on Form 10-K and proxy statements filed with the Commission throughout the relevant period.

In addition, E&Y expressly confirmed to Company A, Company B, and Company C at the end of each affected fiscal year that it was “independent” and therefore able to serve as each client’s external auditor. These written confirmations—called ISB(1) Letters (for Independence Standards Board Standard No. 1, *Independence Discussions With Audit Committees*)—did not disclose E&Y’s business relationship with Thompson until after the relationship was terminated in early May 2004.

3. Respondent Lutze Fails to Respond to an Email Referencing the Relationship

On August 7, 2003, Respondent Lutze—who had been serving as the coordinating partner on the Company A audit engagement since April 2003—learned, for the first time, through an email from another E&Y partner, that Thompson was serving as a “paid advisor to E&Y at the National Industry level,” and that the E&Y partner sending the email was “not sure what this all entails other than some consulting/advisory type work.” At the time, Lutze knew that Thompson was then serving on Company A’s Audit Committee and board; but Lutze took no follow-up action, whether to learn the relationship’s details, or to assess, or have others assess, its independence implications, or to inform Company A of its existence, or otherwise. On April 19, 2004, E&Y furnished an ISB(1) letter to Company A that did not disclose the firm’s business relationship with Thompson. On April 29, 2004, Company A filed its annual report on form 10-K with the Commission, which included the purportedly “independent” audit report that Lutze had overseen.

² For the fiscal years referenced in text that ended prior to E&Y’s termination of its business relationship with Thompson in May 2004, i.e., Company A’s 2002 and 2003 fiscal years and Company B’s 2003 and 2004 fiscal years, E&Y’s audit fees totaled \$2,381,965.

4. E&Y Performs a Flawed Independence Assessment of the Relationship, On Which It Relies in Continuing to Claim Independence Thereafter

By April 2004, E&Y's policies required that matters potentially bearing on independence (i) be elevated for review by the firm's independence office; and (ii) be promptly disclosed, by the relevant coordinating audit partner, to the audit client. On April 19, 2004, as the firm considered whether to renew its relationship with Thompson, Ferraro's direct report notified the firm's independence office of the relationship and inquired whether it was embraced by these policies. The independence office responded affirmatively, thereby initiating an E&Y process that led to Lutze's informing Company A's financial management of the relationship on May 4, 2004. (Prior to that day, neither E&Y nor Thompson had disclosed the relationship to Company A.) At approximately the same time, E&Y terminated its relationship with Thompson and, thereafter, certain E&Y partners for the first time conducted an analysis of the relationship's independence implications. The conclusion reached through that assessment was that the relationship did not impair the firm's independence because it fit within the "consumer in the ordinary course of business" exception to the independence rules' general prohibition on such relationships. See Rule 2-01(c)(3) of Regulation S-X; see also Codification of Financial Reporting Policies, § 602.02.e. This conclusion was erroneous, for the reasons set forth below.

Within weeks, E&Y relied on its erroneous independence analysis in claiming to be independent from Company B, on whose board Thompson had served during the fiscal year covered by E&Y's claim. E&Y's Company B audit report, with this incorrect claim of independence, was filed with Company B's July 14, 2004 Form 10-K and its August 12, 2004 proxy statement.

5. Respondent Lutze Furnishes Letter that Fails Fully to Inform Company A

On May 4, 2004, the same day that E&Y informed Company A of Thompson's undisclosed business relationship with E&Y, Company A immediately asked for and received Thompson's resignation. On May 12, 2004, Company A's Audit Committee, through a member of Company A's management, asked Lutze to confirm in writing that neither he, nor the prior coordinating partner, nor anyone currently serving on the Company A audit engagement was aware, at any time prior to May 4, 2004, of the engagement between E&Y and Thompson. Shortly after receiving this request, Lutze remembered and then promptly retrieved, reviewed, and forwarded to other E&Y partners the email concerning the E&Y/Thompson relationship that he had received on August 7, 2003. Nevertheless, on May 14, 2004, Lutze furnished to Company A's Audit Committee a letter on behalf of E&Y that failed fully to disclose the August 7, 2003 email that he had received. This letter, which was included in Company A's Audit Committee Minute Book, inadequately informed Company A regarding Lutze's pre-May 2004 notice of the E&Y/Thompson relationship. Based on the letter from Lutze, Company A believed that Lutze had no notice of the business relationship between Thompson and the firm before May 4, 2004. This understanding was a material factor in Company A's decision to continue to retain E&Y as its auditor. Company A also materially relied upon this mistaken understanding from the letter in connection with the language of two subsequent filings it made with the Commission: its May 14, 2004 Form 8-K and its May 17, 2004 proxy statement.

6. E&Y Again Fails Fully to Inform Company A's Audit Committee

At the time it requested the May 14th letter, Company A's Audit Committee had also requested a commitment by an E&Y "national managing partner to personally appear" before the Committee at its next meeting and "be prepared to answer all questions of the Committee regarding," among other things, "the reasons why the relationship was not communicated to Company A until May 4, 2004." A senior E&Y official accordingly appeared (along with others from the firm) at the company's June 23, 2004 Audit Committee meeting. The senior E&Y official, who knew of the August 7, 2003 email, stated to the Committee that it was certain E&Y policies, adopted in the Spring of 2004, that caused the relationship to surface, and that E&Y had not disclosed the relationship to Company A earlier because the policies in question were not in place in prior years. The Committee emerged from the meeting with the continued impression that no one on E&Y's audit team was aware of the E&Y/Thompson relationship prior to May 2004. This incorrect understanding was recorded in the Audit Committee's minutes.

F. LEGAL ANALYSIS

1. Independence Principles Governing the E&Y/Thompson Relationship

The basic elements of an auditor independence violation in the business-relationship context are (1) an independence-impairing relationship; (2) existing during all or part of the period covered by the audit, or the period of the audit work, or both; followed by (3) issuance of an audit report claiming to be independent from the client.³ See Rule 2-01(c)(3) of Regulation S-X.⁴ Business relationships with persons associated with the audit client in a decision-making capacity, such as audit client directors, officers and substantial stockholders are embraced by this prohibition. See Rule 2-01(c)(3). Section 6.02.02.e of the Commission's Codification of Financial Reporting Policies ("Codification") (available at 7 Fed. Sec. L. Rep. (CCH) ¶ 73,272) provides, among other things, that:

In addition to the relationships specifically prohibited by Rule 2-01, joint business ventures, limited partnership agreements, investments in supplier or customer companies, leasing interests, (except for immaterial landlord-tenant relationships) and sales by the accountant of

³ An independence violation need not be consummated through the filing of a year-end audit report falsely claiming independence, because the Commission requires that interim financial statements included in quarterly reports on Form 10-Q must also be reviewed by an independent public accountant. See Rule 10-01(d) of Regulation S-X.

⁴ Rule 2-01(c)(3) provides:

An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders. The relationships described in this paragraph do not include a relationship in which the accounting firm or covered person in the firm provides professional services to an audit client or is a consumer in the ordinary course of business.

items other than professional services are examples of other connections which are also included within this classification.

The instant relationship fits squarely within one of the Codification's specific factual examples at Section 6.02.02.e. Example 18 provides:

Facts: A consultant to an accounting firm was also a director and member of the audit committee of a client served by the accounting firm. The consultant's compensation from each of these two involvements was significant in relation to his total earnings.

Conclusion: The apparent conflict of interest which arose from the dual roles of the consultant caused the appearance of the accounting firm's independence to be affected adversely.

As in Example 18, E&Y's relationship with Thompson impaired the appearance of E&Y's independence because Thompson was an audit-client director and audit committee member whose compensation from the relationship with E&Y constituted approximately one-half of his net income.

Rule 2-01(c)(3) provides an exception for "relationship[s] in which the accounting firm or covered person in the firm provides professional services to an audit client or is a consumer in the ordinary course of business." This exception is applicable only if both of its prongs are met, that is, the relationship must be "in the normal course of business" for both parties, and at least one of the parties must be "acting in the capacity of a consumer." See *Commission Letter dated 2/14/89, responding to 3/29/88 Petition by Arthur Andersen & Co. and Others (available at: <http://www.sec.gov/info/accountants/noaction/aaartan1.htm>)* (hereinafter the "1989 Response") at 7-8 (rejecting petitioners' claim that subcontracting falls within the exception because "while the prime/subcontractor provision of services might be in the normal course of the auditor's and client's businesses, neither party is acting in the capacity of a consumer"). Further, in rejecting the petitioners' request to permit prime/subcontractor relationships — "or any other similar cooperative service arrangement" — between auditors and their audit clients so long as they were not quantitatively material to either party, *id.* at 1, the 1989 Response explained that the "closeness and unity of interest inherent in [such] joint business ventures" creates an intolerable risk that "financial statement users [may] question the auditor's objectivity." *Id.* at 8. This risk derives, according to the 1989 Response, from the fact that prime/subcontractor ventures entail the two parties (i) "join[ing] together in a profit-seeking venture," thereby creating a "unity of interest" *id.* at 4; (ii) rendering, to some extent, "the auditor's interest . . . wedded to that of its client" thereby creating a situation of "interdependence"; *id.*; or (iii) working together as "coventurers" to generate "interdependent" revenues from a third party. *Id.* at 6. According to the 1989 Response, any auditor-audit client business relationship containing such features possesses an unacceptable "mutuality or identity of interest" between the auditor and the audit client because, in it, "the advancement of the auditor's interest would, to some extent, be dependent upon the client," which is inconsistent with the essential requirement that the appearance of independence be maintained. *Id.* at 7.

Here, the E&Y/Thompson relationship was a direct business relationship between E&Y and an audit client director, and therefore within the independence rules' general prohibition. The relationship's collaborative nature—as detailed above—gave it the very kind of “mutuality of interest” that the Codification and the *1989 Response* proscribe. The venture does not fit within either prong of the narrow consumer in the ordinary course of business exception. It involved an auditor's and an audit client director's collaboration in creating customized joint products designed for use by third parties. Thompson's past experience with closely similar ventures was limited to just one prior customer; and his relationship with E&Y had been established by high-level signatories on both sides. (Ferraro, who signed the initial contract with Thompson on E&Y's behalf, was a Vice-Chair of the firm at the time.)

2. Violation of Rule 2-02(b) of Regulation S-X and of Issuer Reporting Provisions

Because E&Y's business relationship with Thompson impaired E&Y's independence, and endured for 19 months, it both constituted and caused certain statutory and regulatory violations.

Each time E&Y signed an audit report for Company A, Company B or Company C where either the period covered by the audit, or the period of the audit work, or both, overlapped with its business relationship with Thompson, E&Y directly violated Rule 2-02(b) of Regulation S-X. *See* Rule 2-02(b) (requiring accountant's report to “state whether the audit was made in accordance with generally accepted auditing standards”). Issuing an audit report, or issuing a consent for the filing of an audit report, incorrectly stating that the audit was performed in accordance with the independence requirements of GAAS violates Rule 2-02(b). The E&Y fiscal year-end audit reports incorrectly stating that they were performed in accordance with the independence standards of GAAS included (i) for Company A, reports dated April 1, 2003 and March 29, 2004; (ii) for Company B, reports dated May 27, 2003 and May 26, 2004; and (iii) for Company C, a report dated March 7, 2005.⁵ In addition to issuing each of these reports, E&Y also issued consents for their inclusion with later Commission filings.

Likewise, each time non-independent audit reports were filed with Company A's, Company B's or Company C's annual reports and proxy statements, the issuer violated federal securities statutes and rules requiring that those Commission filings include independently audited financials. *See* Exchange Act §§ 13(a) and 14(a) and Rules 13a-1 and 14a-3 thereunder (requiring annual reports and proxy statements to include independently audited financials).⁶ E&Y bears responsibility for causing all of these reporting violations, since it should have known that the firm's

⁵ The two audit reports referenced in text that were dated after May 24, 2004—the effective date of PCAOB Auditing Standard 1—were required to state that they were performed in accordance with the standards of the PCAOB; while the remaining reports, all dated prior to May 24, 2004, were required to state they were performed in accordance with the standards of GAAS.

⁶ The filings that failed to include or incorporate independently-audited financials included (i) for Company A, annual reports filed May 30, 2003 and April 29, 2004; and proxy statements filed May 20, 2003 and May 17, 2004; (ii) for Company B, annual reports filed July 22, 2003 and July 14, 2004; and proxy statements filed August 4, 2003 and August 12, 2004; and (iii) for Company C, an annual report and a proxy statement filed March 8 and April 6, 2005.

business relationship with Thompson would cause all three issuers on whose boards Thompson sat to lack independent audits and thus to violate the reporting provisions listed above.

Ferraro bears responsibility for being a cause of some of the foregoing violations. Such liability requires findings that (1) a primary violation occurred; (2) an act or omission by the respondent contributed to the violation; and (3) the respondent knew, or should have known, that his or her conduct would contribute to the violation. *See, e.g., Gateway Int'l Holdings, Inc., Exchange Act Rel. No. 53907 (May 31, 2006), 88 SEC Docket 430, 444; Erik W. Chan, 77 SEC Docket 851, 859-60 (Apr. 4, 2002).* Here, by his act of entering into the relationship despite knowing that Thompson served on the boards of Company A and Company B and that both were firm audit clients, Ferraro both contributed to, and should have known his actions would contribute to, E&Y's violations of Rule 2-02(b) of Regulation S-X with respect to E&Y's Company A and Company B audit reports. Likewise, Ferraro should have known his act of entering into the relationship would cause Company A and Company B to lack independent audits and thus to violate the reporting provisions set forth above in connection with their annual reports and proxy statements.

3. Improper Professional Conduct

All three Respondents' actions with respect to E&Y's independence-impairing relationship with Thompson constituted improper professional conduct under Exchange Act § 4C and Rule 102(e) of the Commission's Rules of Practice. Rule 102(e) and Exchange Act Section 4C both define improper professional conduct to include "highly unreasonable conduct" in a situation where the auditor "knows, or should know, that heightened scrutiny is required." The Commission has made clear that auditor independence is *always* an area requiring heightened scrutiny. *See Adopting Release for Rule 102(e)* [Rel. Nos. 33-7593, 34-40567, 1998 SEC LEXIS 2256 (Oct. 19, 1998)] ("Because of the importance of an accountant's independence to the integrity of the financial reporting system, the Commission has concluded that circumstances that raise questions about an accountant's independence always merit heightened scrutiny.") Likewise, the Commission has found negligent conduct where an auditor, when it knew or should have known that independence was implicated, failed to gather all the salient relevant facts pertinent to the independence determination. *Matter of KPMG Peat Marwick LLP*, Rel. No. 34-43862, 54 S.E.C. 1135, 1182-83 (Jan. 19, 2001), *reconsideration denied*, Rel. Nos. 34-44050 and AAER-1374 (Mar. 8, 2001), *petition for review denied*, 289 F.3d 109 (D.C. Cir. 2002).

In this case, there were repeated failures of this nature, including (i) at the point of entry into the E&Y/Thompson relationship, when no independence review was sought despite Ferraro's knowledge that Thompson was serving on the boards of two firm audit clients; (ii) at the point when Lutze received an email referencing the relationship in August 2003, when no follow up action was taken; and (iii) at the point when annual ISB(1) letters were prepared, when the relationship was not identified. E&Y bears responsibility for all of this improper professional conduct, while Ferraro bears responsibility for that occurring at the point of entry into the relationship, and Lutze for the failure to respond to the August 2003 email.

By furnishing to Company A's Audit Committee a letter and an in-person presentation that failed fully to disclose the August 7, 2003 email that Lutze had received concerning the E&Y/Thompson relationship, E&Y and Lutze engaged in improper professional conduct under

Rule 102(e) and Exchange Act Section 4C. Rule 102(e) proceedings are warranted where, as here, (i) the standard violated is within the coverage of Rule 102(e); (ii) the violation was committed “in circumstances meeting one of [the] standards of culpability” articulated in the Rule; and (iii) the violation threatens “the integrity of Commission processes” or “affects the operation of the federal securities laws.” See Rel. Nos. 33-7593, 34-40567 (October 19, 1998) (Adopting Release for the current Rule 102(e)), 1998 SEC LEXIS 2256 at *45 & *58.

With respect to the first factor, the professional standards violated here include ethical rules that were expressly incorporated in the adopting release for the current version of Rule 102(e) in 1998—and whose violation has been the subject of Commission 102(e) proceedings in the past.⁷ Specifically, Rule 102(e)’s adopting release states that the “applicable professional standards” referenced in Rule 102(e) include the AICPA Code of Professional Conduct (“AICPA Code”) (See 1998 SEC LEXIS 2256 at *19.) That Code, in turn, includes Rule 501, which proscribes, among other things, negligently making a communication to an audit client that fails fully to inform that audit client under the circumstances of this case.

With respect to the second factor, the instant conduct was committed in circumstances meeting Rule 102(e)’s “highly unreasonable” negligence standard. E&Y and Lutze should have known that the circumstances of the May 14, 2004 letter to, and the senior E&Y official’s June 23, 2004 appearance before, the Audit Committee were those in which heightened scrutiny was warranted. The Audit Committee had specifically asked for the communications, under circumstances suggesting the Audit Committee intended to rely on them in connection with some action it would take; and the communications touched upon auditor independence—which, as the Commission has stated, is always a matter warranting heightened scrutiny. See 1998 SEC LEXIS 2256 at *34. Thus, by furnishing the May 14, 2004 letter that inadequately informed Company A, and by making a presentation at the June 23, 2004 Company A Audit Committee meeting that did not correct the letter’s inadequate disclosure, E&Y and Lutze negligently permitted Company A to not be fully informed by their communications regarding Lutze’s and the other E&Y auditors’ pre-May 2004 notice of the E&Y/Thompson relationship—and did so in circumstances where they should have known that heightened scrutiny was warranted.

Finally, the instant violation threatened both the integrity of Commission processes and the proper operation of the federal securities laws: the party not fully informed by these communications was a public company; the company’s mistaken understanding concerned a matter that was material to the company; and that mistaken understanding impacted the company’s decisions regarding the language of two of its Commission filings: its May 14, 2004 8-K and its May 17, 2004 proxy statement, as well as its decision to retain E&Y as its auditor.

IV.

Based on the foregoing, the Commission finds that Respondent E&Y (a) engaged in improper professional conduct pursuant to Exchange Act Section 4C and Rule 102(e) of the

⁷ See *In re Clete D. Madden, CPA and David L. Huffman, CPA*, Admin. Proc. File No. 3-12252 (March 30, 2006); *In re Oliver Flanagan, Chartered Accountant*, Admin. Proc. File No. 3-11269 (Sep. 25, 2003); *In re Alan S. Goldstein, CPA*, Admin. Proc. File No. 3-8463 (Sept. 6, 1994).

Commission's Rules of Practice; (b) violated Rule 2-02(b) of Regulation S-X; and (c) caused Company A, Company B and Company C to violate Exchange Act Sections 13(a) and 14(a), and Exchange Act Rules 13a-1 and 14a-3.

Based on the foregoing, the Commission finds that Respondent Ferraro (a) engaged in improper professional conduct pursuant to Exchange Act Section 4C and Rule 102(e) of the Commission's Rules of Practice; (b) was a cause of E&Y's violation of Rule 2-02(b) of Regulation S-X; and (c) was a cause of Company A's and Company B's violations of Exchange Act Sections 13(a) and 14(a), and Exchange Act Rules 13a-1 and 14a-3.

Based on the foregoing, the Commission finds that Respondent Lutze engaged in improper professional conduct pursuant to Exchange Act Section 4C and Rule 102(e) of the Commission's Rules of Practice.

E&Y's Remedial Efforts

In determining to accept the Offer, the Commission considered the remedial steps taken by E&Y. Since the conduct discussed in this Order, E&Y has significantly improved its independence policies and procedures. E&Y has, among other things, established a new business-relationship evaluation process for review and evaluation of both existing and new business relationships.

V.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondents' Offers.

Accordingly, it is hereby ORDERED, effective immediately, that Respondents E&Y, Ferraro and Lutze each be, and hereby is, censured.

IT IS FURTHER ORDERED that Respondent E&Y shall, within ten (10) days of the entry of this Order, pay disgorgement of \$2,381,965 and prejudgment interest of \$537,022.79 to the Securities and Exchange Commission. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies E&Y as a Respondent in these proceedings, and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to J. Lee Buck, II, Deputy Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., N.E., Washington, D.C. 20549-5631.

IT IS FURTHER ORDERED, effectively immediately, that Respondent Ferraro shall cease and desist from causing any violations and any future violations of Rule 2-02 of Regulation S-X, and from causing any violations and any future violations of Sections 13(a) and 14(a) of the Securities Exchange Act of 1934, and Rules 13a-1 and 14a-3 thereunder.

IT IS FURTHER ORDERED, effectively immediately, that Respondent Lutze is denied the privilege of appearing or practicing before the Commission as an accountant. After one year from the date of this Order, Respondent Lutze may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent Lutze's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or
2. an independent accountant. Such an application must satisfy the Commission that:
 - (a) Respondent Lutze, or the public accounting firm with which he is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;
 - (b) Respondent Lutze, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in the respondent's or the firm's quality control system that would indicate that the respondent will not receive appropriate supervision;
 - (c) Respondent Lutze has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and
 - (d) Respondent Lutze acknowledges his responsibility, as long as Respondent Lutze appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

The Commission will consider an application by Respondent Lutze to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters

relating to Respondent Lutze's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Florence E. Harmon
Acting Secretary