



## Ohio Public Employees Retirement System

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February 1, 2005

Office of the Secretary  
PCAOB  
1666 K Street, N.W.  
Washington, DC 20006

Re: PCAOB Rulemaking Docket Matter No. 017, Proposed Ethics and Independence Rules  
Concerning Independence, Tax Service, and Contingent Fees

Dear PCAOB Board Members:

The Ohio Public Employees Retirement System (“OPERS”) is a \$64.5 billion fund serving three quarters of a million Ohioans, making the system the 10<sup>th</sup> largest state pension fund in the U.S. We applaud your efforts and are writing in support of the PCAOB proposed rules to strengthen the auditor ethics and independence rules regarding independence, tax services, and contingent fees.

Despite the significant progress that has been made regarding auditor independence since the passage of the Sarbanes-Oxley Act in 2002 (“Sarbanes-Oxley”), including the eight types of prohibited non-audit consulting services contained in Section 201(a) of Sarbanes-Oxley, some significant trouble spots remain as evidenced by the continuing large-scale corporate accounting scandals and financial restatements that have occurred since Enron and WorldCom.

For example, the Securities and Exchange Commission (“SEC”) recently imposed a six-month ban on new clients at Ernst & Young because the firm violated auditor independence rules when it formed a joint-venture expatriate tax software business with PeopleSoft, its audit client from 1994 through 1999. Ernst & Young and PeopleSoft entered into mutually beneficial arrangements designed to lead to cross-selling other Ernst & Young services and PeopleSoft software, including a Licensing Agreement that provided the greater the sale of the software for PeopleSoft, the higher the royalties that Ernst & Young paid to PeopleSoft. Given the recent accounting problems at Sprint where Ernst & Young served as its auditor, it is also interesting to note that Sprint was Ernst & Young’s largest software implementation client and also a major client of PeopleSoft.

In order to further strengthen the auditor ethics rules, we also strongly urge the PCAOB to incorporate the four principles contained in the Preliminary Note to the Securities and Exchange Commission's ("SEC") auditor independence requirements, Rule 2-01(b), into the PCAOB proposed auditing standard. OPERS believes that these principles should also apply throughout the entire audit engagement. These four principles state that auditor independence may be impaired if the relationship with its audit client:

1. Creates a mutual or conflicting interest between the accountant and the audit client;
2. Places the accountant in the position of auditing his or her own work;
3. Results in the accountant acting as management or an employee of the audit client; or
4. Places the accountant in a position of being an advocate for the audit client.

Accordingly, auditors have traditionally served as gatekeepers to the public securities markets, which is crucial for capital formation in the U.S. Auditor independence is an integral part of the auditor's public watchdog function and serves two very important objectives. The first objective is to foster high quality audits by minimizing the possibility that external factors will influence an auditor's judgment and the second objective is to promote investor confidence in the reliability and accuracy of the financial statements of public companies. Public confidence in the reliability and accuracy of a company's financial statements is of critical importance and depends, in large part, on public perception of the outside auditor as an independent professional, which requires both independence in fact and independence in appearance. In the absence of rigorous examination of public company financial statements by objective auditors, public confidence is eroded and investors become less willing to invest in the securities of publicly traded companies.

OPERS and other investors believe that Sarbanes-Oxley did not go far enough to ensure auditor independence when this federal legislation failed to prohibit the auditor from selling certain tax strategy services to audit clients such as high-risk tax shelter products, a financially lucrative and growing industry that Sarbanes-Oxley left to the discretion of the audit committee. As documented in a July 2003 GAO report on Public Accounting Firms conducted for the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services on Public Accounting Firms, in 2002 the Big 4 accounting firms had revenues ranging from \$979 million to \$1.7 billion from tax services the accounting firms provided to U.S. clients.

Although there is presently no uniform standard as to what constitutes a tax shelter, the Internal Revenue Service ("IRS") describes them as very complicated, confidential transactions, often composed of many pieces located in several parts of a complex tax return, that sophisticated tax professionals promote to corporations and wealthy individuals to reap large unintended tax benefits. As of August 2003, the IRS has listed 27 types of abusive tax shelter transactions.

Since the enactment of Sarbanes-Oxley in 2002, abuse in the tax area that involves the auditor continues as illustrated in 2003 when investors learned that Sprint's auditor, Ernst & Young, recommended tax shelters to the company's then-Chairman and CEO, William Esrey, and President, Ronald LeMay (also a Sprint Board Member) that permitted the executives to avoid paying taxes on more than \$100 million each in stock-option gains, which has now been challenged by the IRS. Current examples of continuing abuse in the tax area are illustrated by Qwest and WorldCom where the auditor, KPMG, served in the dual capacity of both auditor and tax shelter consultant at both companies, which is still under investigation.

Although it may be appropriate to continue to permit the auditor to perform certain limited, routine tax preparation services related to the audit, when auditors are either permitted to audit their own work or the circumstances create the appearance of a mutual interest, significant conflict-of-interest issues arise that increase the likelihood of financial harm to investors.

Moreover, OPERS believes that the PCAOB should consider going even further than the proposed rules to not only prohibit the auditor from providing tax services to the executives that oversee the preparation of financial statements, but also prohibit the auditor from providing these types of tax services to individual corporate directors serving on the audit committee, which is responsible for hiring, and when necessary, firing, the external auditor. We also recommend that the PCAOB consider a final rule that incorporates a standard that covers any senior officer or director who has "significant influence" over the financial statements. Under a "significant influence" standard, given the fact that one of the main reasons for financial restatements continues to be improper revenue recognition, it may also be appropriate to include the Vice President of Sales as someone who is in an oversight role and has "significant influence" over the financial statements. Such a standard would be consistent with the PCAOB proposed definition of affiliate of the audit client, which also includes a "significant influence" component.

Finally, we fully endorse the PCAOB's proposed definition of an affiliate of the accounting firm and we support the PCAOB's proposal to eliminate the tax matters exception to the SEC's general prohibition against contingent fee arrangements between an auditor and its audit client. The SEC has deemed that such contingent fee arrangements impair the auditor's independence. For example, in July 2002 the SEC found that PricewaterhouseCoopers ("PwC") violated the auditor independence rules over a five-year period from 1996 to 2001 when the firm used prohibited contingent fee arrangements with 14 different audit clients who also received investment services from the firm's broker dealer affiliate, PricewaterhouseCoopers Securities, and for PwC's participation with two other audit clients in the improper accounting of costs that included PwC's own consulting fees. The SEC indicated that this case was a good example of the heightened risk of audit failure created when an accounting firm assists in and approves the accounting treatment of its own consulting fees.

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Investors are aware that contingent fee arrangements are being used with increased frequency in the tax consulting area where the fees may be tied to the “success” of the tax avoidance advice. As the PCAOB points out, this narrow exception may have recently been misinterpreted by the AICPA and OPERS fully supports the PCAOB’s efforts to clarify and enhance the auditor independence auditing standards as it relates to contingent fee arrangements. In addition, in order to ensure that the audit committee of a public company remains fully informed about the existence of any contingent fee arrangements between the auditor and the audit client, OPERS believes that the auditor should be required to provide the audit committee with an actual copy of the audit engagement letter and any side letters or other related agreements.

We applaud the PCAOB for addressing these important issues. Should you need any additional information, please feel free to contact Cynthia Richson, OPERS Corporate Governance Officer and a member of the PCAOB Standing Advisory Group, at 614/222-0398.

Sincerely,

A handwritten signature in cursive script that reads "Laurie Fiori Hacking".

Laurie Fiori Hacking  
Executive Director