Fireside Chat on Professional Responsibility
November 1, 2005

Theresa Gabaldon: Good afternoon and welcome to the concluding program in the 2005 series of Fireside Chats of the Securities and Exchange Commission Historical Society. I'm Theresa Gabaldon, Professor of Law and Carville Dickinson Benson Research Professor of Law at The George Washington University Law School, and the host of the chats this year.

The Securities and Exchange Commission Historical Society is a non-profit organization, separate from and independent of the SEC. The Society preserves and shares the history of the SEC and of the securities industry through its virtual museum and archive at www.sechistorical.org.

Today's chat will be preserved in the museum so you can listen to the discussion or read the transcript later. Today's Fireside Chat looks at professional responsibility for practitioners of law and for practitioners of accounting. Joining me today are Barry Melancon, President and CEO of the American Institute of Certified Public Accountants, and Thomas D. Morgan, Oppenheim Professor of Anti-trust and Trade Regulation Law at The George Washington University Law School.

Tom also is one of the best known authors and teachers in the field of legal ethics. The 2005 Fireside Chat series is made possible in part through the support of Pfizer, Inc.

The remarks made today are solely those of the speakers and are not representative of those of the Society. Our speakers cannot give investment or legal advice. Berry and Tom, welcome.

I'm sure we can assume a fair amount of sophistication on the part of our listeners today, but not omniscience. So it probably would be useful to provide a little background. To do that, I'm going to ask each of you to answer two questions about your respective disciplines. First in the case of accounting, Barry, what bodies of law and/or sets of rules govern the conduct of those practicing before the Securities and Exchange Commission?

Barry Melancon: There's a series of laws. You pointed to Rule 102(e) of the Securities and Exchange Commission under which an accountant or CPA is required to be professional and adhere to a whole myriad of standards.

Rule102(e) would say that it would prohibit unprofessional conduct by an accountant that includes intentional misconduct, recklessness, repeated acts of negligence, or single acts of negligence that might reflect a significant departure from what is known as generally accepted auditing standards. When we focus on the term, "generally accepted auditing standards," then we get into a whole new series of responsibilities or layers.

Today the Public Company Accounting Oversight Board, the PCAOB, has, under Sarbanes-Oxley, the authority to set those standards for the audits of public companies. That body of knowledge, that body of rules, would be what a CPA would have to adhere to in the conduct of an audit of a public company.

Those rules today are predominantly the historical auditing standards that were originally propagated by the AICPA. When the PCAOB was formed, it adopted those rules, and now, adopts additional rules as it sees fit to protect the public interest.

There is also a series of rules governing the ethical conduct of CPAs. Some are reflected in the PCAOB's rules. There is also a series of rules of conduct in whatever state the CPA might be practicing or licensed in.

There is also the code of conduct promulgated by the American Institute of Certified Public Accountants, the organization that I head. Those rules would generally be similar to the others, though there could be some differences depending on a public company versus a private company.

Then you have the SEC's antifraud rules – such as Rule 10(b)-5 and Section 10(A) of the Exchange Act, that also sets a whole level of conduct that the CPAs must follow if they uncover fraud or if they have a knowledge of fraud related to a particular client.

Theresa Gabaldon: I think that, in your answer, you anticipated my second question, which was: in a nutshell, can you describe that standard of conduct? Obviously it would be very difficult to do with so many standards, but perhaps you could address for us the bottom-line: are these standards a difficult thing to comply with?

Barry Melancon: From a professional responsibility standpoint, if we look on the ethical side, the principle is independence, obviously. Independence of thought, independence in fact, and there's a whole myriad of interpretations and rules that go along with that particular issue.

They do get pretty complex. If we go back in history, it was not a problem, for instance, for an auditor to actually own stock in a company that they audited. And that was many, many decades ago. Obviously, today that is a prohibition. Many accounting firms have become very large and very complex and as a result, you have rules about where ownership can exist, and where conflicts exist based on the teams that are involved in a particular engagement.

So it's not so easy to pinpoint a single set or a simple concept other than to say that the overall concept governing the audit is independence. The auditor sits in a unique position and is intended to protect the public and protect the investor by being independent of the company and expressing his or her opinion on the financial statements of that company.

Theresa Gabaldon: Thank you. Tom, I'm going to ask you the same two questions, again, just by way of background. What bodies of law and sets of rules generally govern

the conduct of those practicing law before the SEC? And is it possible to thumbnail the scripture of the relevant standards?

Thomas Morgan: Theresa, the fundamental regulation of lawyers is state regulation. Lawyers are licensed by individual states and it is from those state licenses the lawyer gets the authority to practice law in any field. Those state rules applicable to lawyers vary among the states.

For example, a lawyer in New Jersey might have quite different obligations than a lawyer in California would with respect to particular kinds of information. It's simply a crazy quilt to some extent of rules and regulations applicable to lawyers.

There is a standard or set of model rules that has been promulgated by the American Bar Association. But those are only models and the states then adopt them. In addition, certain federal agencies, including the SEC, have promulgated rules applicable to lawyers who practice before those agencies. And in the case of the SEC, the obligations are general in terms of the obligation of accuracy and honesty in the documents that are filed.

And in addition, a series of regulations recently promulgated pursuant to the Sarbanes-Oxley Act get much more detailed. Essentially the content is two-fold, both at the state level and the federal level. One is a requirement that a lawyer not make a material misstatement of fact to anybody. So there's a general obligation that lawyers be honest.

Second, there's a general obligation that lawyers protect confidential information of their clients. And the tension between the duty of disclosure and the duty of confidentiality is at least part of where the issues have been in recent years.

Third, there is an obligation to protect the interests of the organization, the corporation, against persons within it who try to take advantage of it – that is people who either steal from the company or seek to defraud investors or whatever. When a lawyer sees the individuals in the organization taking advantage of the organization or creating potentially serious losses for the organization, then there's an obligation that the lawyers to step in.

Theresa Gabaldon: Barry, given your basic description of standards, I wonder if it would be possible for you to now step back just a bit and talk about how you think accountants can conceptualize their role in the capital raising process.

Barry Melancon: Confidentiality, as Tom mentioned for the lawyers, falls into that role. But the role of the CPA is as an independent person, looking at the financial statements. The capital market system takes investor money from a very disparate lot – thousands and thousands of shareholders - who are not close to the company in any way. These shareholders make investments in the capital market system in the U.S. and they rely on the information flow to make those investments.

Maybe the shareholders rely on the analysis from investment analysts before they make those investments, but their investments are based on what they expect to be concrete, reliable information. That's the concept. The CPAs view themselves today, and have historically viewed themselves, as sort of the objective eyes on behalf of the shareholders looking at management, looking at governance, sitting between the shareholders and management, and looking at the reasonableness and appropriateness of financial information so that good decisions can be made.

The United States has the most efficient capital markets in the world, despite the difficulties we went through in the last few years. The reliability of information, the transparency of information, and the importance of reliability and transparency, brings a significant factor of efficiency to the capital markets.

I think that , in the CPAs' view, their role in the financial reporting area is as a pretty significant cog in the efficient flow of information which reduces the cost of capital, which enhances the investor public, and which obviously helps to set up our capital market system to succeed. The more people know about a particular investment, the more likely they are to make a wise choice. With the free flow of information, people will invest in the best opportunities and the best companies.

That's a very important role. It is very difficult from an economics standpoint to put a dollar amount or to quantify a specific cost of capital factor. But clearly, I think if you compare our markets with those around the world, the fact that we have that transparency and we do such a good job, that we in the U.S. generally have a lower cost of operation from a capital perspective than in other parts of the world.

Today, in the area of Sarbanes-Oxley, we have empowered audit committees. The CPAs view their role as working for the audit committee on behalf of the investing public. That is a position that this profession has supported since the 1960's, but it's only really become a requirement with the passage of Sarbanes-Oxley. The audit committee is the representative of shareholders, which picks the auditor and really sits between management and the auditor.

At a macro level, it's the sufficiency of capital supporting the transparency and free flow of information that makes capital move more freely. It is a very important role and as far as the execution of that role, it's through the interaction with representatives of shareholders which are manifested by the audit committee.

Theresa Gabaldon: Tom, do you think you can compare and contrast the lawyer's view of him or herself in the capital raising process?

Thomas Morgan: I suspect it's fair to say that most lawyers don't take quite the macro view that we just heard. Most lawyers see their obligations as largely a) keep their clients out of trouble, and, as another way of saying that, b) adhere to the law. The object of the lawyer is to help the client in the capital raising process by complying with the regulations of that process.

Lawyers tend not to evaluate the quality of the investment or the wisdom of providing certain information. If you're required to provide it, you provide it. But whether it's a good idea to provide it, is not typically the question the lawyer asks.

I think lawyers view their task somewhat narrowly. But the challenge of trying to figure out what the law really requires, or what information must be disclosed that the company doesn't want to be disclosed, tends to be where the issues of professional responsibility for lawyers arise.

Theresa Gabaldon: One read a great deal these days about the role of various gatekeepers in capital raising and I've seen that term applied both in the context of accountants and in the context of lawyers. I'm wondering whether gatekeeper means the same thing as police. Barry, I'll ask this of you first because I read an article not too long ago with the title, "Accountants Make Miserable Policemen." Are they supposed to be policemen in the process and are they any good at it?

Barry Melancon: I don't think policemen is a good metaphor in describing the role. The concept of policeman can be prevention, it can be investigative, it can be enforcement, it can be things like crowd control; you can make different analogies to the financial reporting spectrum. From an enforcement perspective, there is a whole series of laws and regulations. Clearly the SEC has an enforcement responsibility and it has a role that you could equate to a policeman role.

I like to look at it a little bit differently. Financial reporting has many different players. When we talk about financial reporting, we inevitably have to talk about fraud, and the detection and prevention of fraud. If you want equate it to the manufacturing process, if we were making automobiles, there are many components in that process, from design and engineering all the way through production and quality control at the end.

The fact is that the independent accountant is only one part of the financial reporting process. There are roles for senior management, which are very important; there are roles for boards and audit committees, there are roles for regulators, there are even roles for employees and vendors and suppliers; and yes, there's a check and balance role for the audit function.

Every one of the components has a role in making sure our financial system is as good as it possibly can be. We would not go into a manufacturing business, and simply rely on the inspection process at the end to determine quality. That's not how we would be competitive in the marketplace. We cannot rely on the auditor at the end to be the sole responsibility. It is an important part of that responsibility, but it's not the sole responsibility.

The article that you cited - do they make good policemen - I think implies the notion that they don't necessarily catch everything. Well, policemen don't catch everything either.

When we have an unsolved crime, we don't necessarily point fingers at policemen for not having done their job correctly.

So I think it's difficult to make that particular analogy to the term policeman. I prefer to look at it as an entire financial reporting process and everybody has to do their part to get to the positive outcome.

One of the reasons why people say, maybe the profession doesn't do the job on that, - and I believe it's a very unfair comment - is that we only hear of those bad situations. Now, we don't ever want a bad situation. Everybody wants 100% quality. I'm sure every leader in corporate America, the vast majority of whom are upstanding citizens, want 100%. They don't want fraud and they don't want mistakes in financial statements, but some do occur.

Because of confidentiality and because of the balancing of this information flow, there are so many times the auditor has said no to things and has required other action that we will never know about. We don't ever hear about those items prevented. We only hear about those items that the financial reporting process did not prevent. Yet all along, people prevent things and take the right action.

Confidentiality of information flow prevents us from ever knowing about the thousands of examples where the right thing is done.

Theresa Gabaldon: Tom, I've certainly read the same term thrown around in the context of lawyers. Is it proper to think of them as gatekeepers and/or policemen?

Thomas Morgan: I've never liked the term gatekeepers, but I think it can be understood. If you think of the process of capital raising and as passing through a series of professionals, people describe the fact that you have to come to a lawyer and get a legal opinion and get approval of your documents, before filing, as a gate that you have to pass through. But as Barry said, there's a whole series of these gates and the mistake is assuming that any one of them is the enforcement authority.

I remember hearing, when I was in law school, that the most effective enforcement of the securities laws occurs in a lawyer's office. That is to say, all those things that the professional advises the company not to do or says would be illegal, causes the practices to change in appropriate ways. But, that doesn't mean that most lawyers view themselves or should view themselves as primarily adversaries of their clients. Their objective is to help the client achieve what the client ought to want to achieve, namely, compliance with the legal requirements involved in raising capital.

Theresa Gabaldon: I remember hearing that exact same quote when I was in law school. Maybe we had the same teacher. I'm going to turn the conversation next to the question of whether there have been any changes over time, in our vision of what the profession should be contributing to the capital raising process.

Barry Melancon: There has been significant change. The relationship with the audit committee, a much more empowered audit committee, as well as the relationship between the auditor and the company, is different today. There are services that are proscribed today under Sarbanes-Oxley, that, in the past, the audit firm could do. There is now a separation of services so that there is not the appearance or the fact of conflicts of interest.

I think another area that has evolved is the getting-it-right notion. We have to remember that financial statements are the company's financial statements, not the auditor's. The auditor expresses an opinion as to whether as a whole those financial statements are deemed fair or materially correct.

And throughout history, or at least recent history, it has always been a consultative relationship between the CPA, auditor and the CFOs to understand a very complex transaction and figure out the right way to present it.

The environment that shifted post-Enron and WorldCom into the Sarbanes-Oxley world put some barriers. I think expectations are that management has to absolutely make a decision on what's right in accounting, and give the right answer related to a very complicated transaction. The auditor is deemed to be the second look, that second set of eyes.

The problem, of course, is that different size companies and different complexities of companies have different relationships and I don't think we want in our financial reporting world a "catch me if you can" type of environment.

I think in virtually all circumstances, a more rational consultative process, where the auditor can maintain his or her independence, but the consultative shared knowledge produces the best possible result, is in the end, much better for the investing public. I think in the post Sarbanes-Oxley world, the pendulum shifted very far and I think there are a lot of concerns in corporate America along the lines of, "I can't get any type of consultative help in making some of these tough decisions because my auditors have to take an independent look." That's not in the best interest of the investing public. I think today people are starting to recognize that the pendulum has shifted too far.

Surely there is a better solution so that people can have their consultation and get to the right answer. We can't lose sight of the fact that the huge percentage of the people involved in financial reporting want just that. They want to get it right.

Being able to communicate about that is the better answer. We have a system in this country that is the catch me if you can audit environment. When an IRS auditor comes in, people don't want to say, this is where I sort of struggled with this transaction and didn't think it was right. It's more, let the IRS agent find it.

Well that's not the best approach for financial reporting. It's much better to have that CFO, the person responsible for that company's financial statements, to speak to the

auditor and say, look, this is a very complex transaction. These are the nuances that we're thinking about, and this is where we don't see guides. What do you think is the right answer? Point me and help me make sure I'm focused in the right direction, to come to that right answer.

The auditor can do that and still maintain the independence and objectivity and the second look that is required. And the result of that is better financial reporting.

Thomas Morgan: I think it's fair to say that lawyers, speaking generally now, 10 years ago or more, had a view that their role was to help clients comply with the rules, but to just comply with the rules. That is to say, figure out where the rules were ambiguous, and perhaps, not go as far as they might in complying. I remember seeing a sports show the other day where one of the basketball players was demonstrating how to push another player off without getting caught and I think there was a sense at one time, that lawyers were to get you where you wanted to be and just barely comply.

It's really changed now. We had a number of savings and loans cases, back in the early '90s, where there was substantial liability for lawyers, as well as accountants, in representing those companies. But we're seeing the same thing now, in the corporate difficulties of recent years.

The Sarbanes-Oxley Act has thrown the fear of God into a lot of corporate managers. They don't want to go close to the edge of the law, the lawyers don't want to go close to the edge, and the name of the game is to do it right.

In terms of whether or not the changes in substantive regulations have been desirable, I think the changes in the ABA's model for the states has been extremely helpful. Lawyers were encouraged by the American Bar Association's advice to the states not to disclose certain kinds of information about their corporate clients because it was said to be confidential, even if it was not legally protected. That is to say, it wasn't privileged and there was no other legal protection. The company had an obligation to disclose it.

But the lawyer could not disclose it if the client did not. The ABA has changed the rules now, so that to the extent the states adopt those changes, and many are, lawyers will unquestionably be able to either disclose themselves or through threat of disclosure, cause their clients to make the disclosures that need to be made.

The same kinds of pressures have been created by the Sarbanes-Oxley Act and the SEC's regulations. My own view is that the SEC's regulations are a bit more rigid and it's not that they make you disclose more, it's that they require you to disclose to particular people. If you disclose to the wrong person or you don't get a follow-up within a certain period of time, you have some potential liabilities.

That seem to me to go too far, and to fail to distinguish the wide variety of potential problem cases that lawyers may face. But apart from that, I think the move to increase

lawyer responsibility for assuring that the client stays well within the legal bounds and doesn't try to find the loopholes is unquestionably the right direction to go.

Theresa Gabaldon: Barry, you didn't sound so sure that the cultural change, with respect to accountants, had been such a good thing. Do you think that this is society or the SEC telling us that lawyers were at one point, so bad that they needed to be brought up to snuff and that's been a good thing? But accountants had it about right in the first place and they'd been pushed in the wrong direction?

Barry Melancon: No, I was just saying that, solely as it relates to this process of dealing with complex issues, that a "catch me if you can" environment, where there's a total separation between management and the auditor, might not produce the best result. The best result is with free information exchange and consultation so the brightest minds can get to the right answer.

Thomas Morgan: I'd simply pick up on what Barry's saying and say that lawyers have very much the same problem, if not a greater problem, in that we really don't train lawyers very well to understand the kinds of accounting issues that Barry's talking about and the kind of finance issues that both of our professions have to struggle with. Creative financial management, in the best sense of that term, is desirable and indeed one of the things that makes American companies stand out. It's when those creative instincts turn into deceitful practices that we have a problem and if it's hard for accountants to figure out whether financial accounting is being handled correctly, it's doubly difficult for lawyers and that is one of our continuing challenges.

Barry Melancon: Included in the complexity of all of this, particularly with regard to large companies, you have diversification strategies, both geographical and those based on business lines. New types of transactions are always being entered into, thought of and structured differently. It's not just a constant set of facts and transactions.

It's very important to recognize that this complexity needs to be handled in such a way that rational minds can get their hands around it. You asked about things that are different. For instance, what might happen in a audit committee meeting today? First off, audit committees are, under Sarbanes-Oxley, essentially required for all public companies. They're independent audit committees; they have to have at least one person with financial expertise.

Those are all very, very good changes, but now the dialogue that's happening in these audit committee meetings is much different than what was happening pre-Sarbanes-Oxley. There's a greater vetting of the issues of the company. For instance, there is a discussion between the auditor and the audit committee about some of these complex transactions and whether or not the auditor believes the company's position is conservative or aggressive.

It's a discussion about so-called past adjustments. So there's an attempt to communicate, to have the audit committee, which is directly the representatives of shareholders, gain a

more thorough understanding of sort of the things that were wrestled with between management and the auditor.

Thus, another set of eyes, other than just the auditor and management, is also weighing in on the type of transaction and the difficulties associated with it. That's a good thing. It produces more dialogue and more decision making. You can't do that in the public domain, you can't do that with tens of thousands of shareholders. Audit committee members are the independent representative to listen to these issues and make a judgment call on it.

Theresa Gabaldon: Do you think that we're likely to see more changes, either in rules or in the cultures, and in first of all, the accounting and then the legal profession?

Barry Melancon: Well I would think if you wanted to go to Las Vegas, the thing that you could definitely bet on is there will be more changes. The fact is that there are constantly new transactions, there are new types of entities, there are new opportunities that businesses face.

Regulatory components and legislative components all create more changes and quite frankly, in this environment, there is some push back. Smaller companies are saying, "some of the rules are too burdensome, they don't allow me to cost effectively access public capital, and they might impede my growth." The jury is basically out on some of that debate. But all of those factors mean that there will be a constant evolution and I don't think you can pick any time in the history of financial reporting that there hasn't been a constant evolution.

Theresa Gabaldon: Tom, I think that Barry already took care of this with respect to the accounting profession, but before you discuss if any more changes might be in the offing, I'd be interested in hearing your view about whether there have been any changes in lawyer's relationships with their clients.

Thomas D. Morgan: I think this is the area that many lawyers worry about. There has been, to some extent, a change in the relationship. The historic view, that anything you told your lawyer wouldn't leave the room, is changing now. There is authority for lawyers to disclose information that they believe needs to be disclosed under the Sarbanes-Oxley regulations, for example.

There's authority under the ABA model rule changes to disclose things that may relate to crime or fraud and indeed an obligation to do that. And in the securities area, it's both crime and fraud if you're found to be violating the securities laws. So we are talking here about a world in which the relationship of trust, has been, to some extent, decreased.

I think it's been beneficial to have everybody understand that this isn't a game anymore. We aren't trying to find out where the edges to the rules are. We're all trying to comply and in that environment, then presumably what you're telling your lawyer you would have happy to have disclosed. You're going to correct the situation rather than continue

with it. One of the areas that really is a problem for many lawyers and one of the reasons there is a debate continuing particularly within state bar associations is about the appropriateness of SEC regulations in this area, and is the concern that people will be less likely to be candid with their lawyers because they fear the information can or will be used against them.

Theresa Gabaldon: Would you say that changes in the rules have given us a new vision of who our client really is?

Thomas Morgan: Historically, of course, we've said the client is the corporation. And I think that is still true, but it was inevitably the case that many lawyers viewed their clients as the managers of the organization. Those were, after all, the people who hired the lawyers. It has always been the case that the lawyers have had, through their obligations to a corporation, an obligation to investors, not a separate obligation that's necessarily enforceable by a malpractice suit, but an obligation to protect the interests of the corporation and thus to serve the interests of investors.

Certainly under the securities laws, the compliance with those laws is a central part of protecting the interests of investors. So I don't think it's a technical change in who our client is but the sense that the client is a lot broader than the corporate managers. Either this has become a part of the lawyer's accepted wisdom or better become part of it very soon, or the lawyers are going to be in trouble.

Barry Melancon: I think that Tom's point echoes the issue of the audit committee on the audit side. The shareholders and the audit function were always focused to the shareholders, the investing public. The changes that Sarbanes-Oxley brought about really empowered the audit committee.

They are more behavioral change rather than maybe technical changes. I would agree with Tom's assessment.

Theresa Gabaldon: And Tom, if you were polishing off your crystal ball, do you see more changes in the offing?

Thomas Morgan: I would be surprised if there were substantial changes in increased disclosure by lawyers or substantial change in the role of lawyers. I think we may see a pull back from Sarbanes-Oxley.   Politically, that's going to be difficult, because nobody wants to look like they're weak on ethics, but for the same reasons that Barry was describing, there is such a range of problems. We may come to believe that the obligations that Sarbanes-Oxley imposed, quite specific obligations, need to be made more flexible.

There's an issue that we haven't discussed at all, which is the relationship between lawyers and accountants. And that's a very open issue nowadays. We've historically had a treaty, as it's sometimes been called, as to what information lawyers were to supply to auditors. It is a somewhat open question today whether that treaty, adopted now 30 years

ago, is still in force or will allowed to remain in force or will be changed in some way. That is an area of potential change that I think both auditors and lawyers will need to keep an eye on.

Theresa Gabaldon: Would you say there's active renegotiation, right now, Barry?

Barry Melancon: Liability issues associated with the company are very important aspects of the financial presentation of that company. As Tom has called it, a treaty, the communication flow that existed in that environment, is about the assessment of liabilities and what the likelihood of those outcomes are. It's management's financial statements that first make that assessment. And management does that obviously in consultation with lawyers, because management itself is not in a position to make that legal assessment.

The auditor has a communication role with the lawyer to understand whether or not that assessment is appropriate and reasonable, and if it should be disclosed or not in the financial statements. So obviously, that's a fairly important piece of information for an investor, to understand the liability risk of associating with a company as it relates to the ability of that company to proceed and be profitable in the future.

The auditor himself is not a lawyer and is not in a position to make that legal assessment. I don't think the lawyers want the auditors making that legal assessment. There's all sorts of liability risks associated to the professional that's involved in that process, be it a lawyer or the auditor.

But we live in a very litigious society. There's a very limited number of companies that do not have, at any one time, significant potential litigation that has to be assessed in the context of appropriate financial reporting.

Thomas Morgan: There is one other issue that might be worth mentioning. And that is the issue of the attorney client privilege and auditors, in connection with internal investigations. For example, there's been a situation in which the lawyers did an internal investigation of the company and the auditor says, I don't just want to know the answer you came up with; I want to know what you really learned, and show me all the interviews. If the lawyer gives that information to the auditor, which the auditor may indeed feel he or she needs, there's a potential for losing the attorney-client privilege. That is another area where, again, we're just identifying some areas where the law is not going to remain static, but where's there is going to be a continuing discussion and we'll simply see how it comes out.

Barry Melancon: The auditor can face certain liability issues from a fraud detection perspective, and to say they don't have access to information when making their judgments on the financial statements, that's a pretty significant scope limitation. We certainly understand because we face it in the CPA profession. In this case, Tom is describing a potential increased exposure to the company because of loss of that

privilege, but at the same time the auditor gets off-loaded some of that liability if they don't take access to it.

Thomas Morgan: Point is, these are tough issues and there will be continuing discussion of them over the years.

Theresa Gabaldon: Do you see things working themselves out quickly or is it going to take years and years for these issues to be addressed?

Barry Melancon: I think it is important to understand that we are still in the infancy of a post-Sarbanes-Oxley era. It takes time for all of those things to filter through the system. In the grand scheme of things, we are still relatively in the infancy of this new regulatory regime and I think probably the biggest mistake all of us could make would be to overreact and make additional changes or even to pull back where it might not be totally thought out. Our enterprise system is very complex and I think we need time to study and have a meaningful analysis of what the impacts are.

Too quick of a change will probably not be the right answer. That being said, I think, because you have regulation through the SEC, you have standard setting through the PCAOB, there is going to be an evolution of certain issues that people will want to address and need to be addressed. And they will do that through regulation and through standard setting. But as far as a massive change, my opinion is that the attitude on Capitol Hill would be that this might be a little too soon.

Thomas Morgan: I think the problem is that you need events that are dramatic sometimes to get people taking issues seriously. I agree with Barry completely that what you get out of the processes that follow dramatic events often are not the best thought out. I think we ought to expect the change is going to be constant in this area and that we will get some of the changes right and we will get some wrong and correct those hopefully over the years.

Theresa Gabaldon: I am interested in asking a few specific questions that were fairly practical. Barry, let's say you have a public client with off balance sheet accounting practices that go somewhat beyond the merely creative. What do you do about it?

Barry Melancon: You basically are implying that something is fraudulent there, in which case you have an obligation to raise that with the highest level of management not directly involved in the matter in question. You also have an obligation to require an investigation. If management does not take responsibility, if it does not act appropriately, the auditor has an obligation to inform the audit committee. Ultimately through a series of steps in this process, if the board fails to take appropriate action, the auditor has a responsibility to resign the engagement or notify the SEC. And there are various steps in that process. All along the way, if it doesn't reach all the way to the end of that process you have an obligation to assess the impact on the fairness of the financial statements that you are opining on as to whether that condition is changing the outcome.

So if in fact it is not fraudulent, but you do not believe that it reflects fairly in the financial statements, then you could have an exception in your reporting or in the financial statements themselves. So I think it is very important to understand that, that when you become knowledgeable of or aware of these particular issues as an auditor, you do have an obligation to raise the issue to the highest level and to see that appropriate action is taken. And ultimately, if no action is taken by the company, there is a reporting responsibility to SEC.

Theresa Gabaldon: Going to interaction of lawyers and accountants for a minute, Tom, let's suppose that you see an accounting practice that makes you scratch your head but the CFO says it's okay. Do you call the outside auditor?

Thomas Morgan: Traditionally, under state law, I think the lawyer's instincts would be to try to find the shortest route to satisfying themselves that all is well. If Barry is the outside auditor, as opposed to a consultant - I am not sure Barry can tell us better whether I can call him or whether he could answer in the first place about matters that were not connected directly with the audit, that is were simply transactions that came up in the course of the year.

But what I am trying to say is historically lawyers would try to find the short route to the answer, and if the auditor was able to supply that information that would be a helpful course. Now under Sarbanes-Oxley, the lawyer's course would be to report this concern to the chief legal officer of the company, typically the general counsel of the company, and it would be the chief legal officer's obligation to prepare some kind of a report that would satisfy the lawyer that all is well. That could be bringing in another accounting firm. That is an illustration of the change that I was raising some doubts about, because when you formalize it in this way, you do get a formula for getting a report back and making sure that you have got a documented demonstration that the practice is correct. On the other hand, it may be making an expensive process out of what ought to be relatively simple if the lawyer were able to be satisfied by just a phone call.

Theresa Gabaldon: And Barry, flipping the picture, I think that you indicated earlier that if the auditor knows that an issue is being sued for something like an anti-trust violation, you would ask the issuer's counsel about it. Tom, if you're that counsel and you think the prospects for your client actually look pretty dim, what do you say or do?

Thomas Morgan: Well, if you think that it is likely that you are going to lose, you are basically required to say that it's likely you're going to lose; that is part of what this treaty that I referred to earlier is all about. You don't say that if it is not pretty clear you are going to lose, because admitting it to your auditor in a context that is not privileged or probably not privileged, is just an admission to the other side that you think you are going lose and affects very significantly or the potential settlement value of the case.

So the lawyer's obligation of confidentiality within a large range of a possible success or failure in a case requires that the lawyer not provide a very detailed information about the prospects of when you are losing. That is an area of constant negotiation nowadays.

There are audit firms that are requiring their clients to demand their lawyers that they turn over much more detailed information if for example the lawyer has, in a privileged setting, given the client an estimate that it is 70% chance it is going to lose.

The auditor would want that information. The lawyer would not under the treaty be obliged to supply it and the question is whether it ought to be supplied or whether it shouldn't. I can understand why the auditors want it, but you can also understand why the lawyers don't want to provide it, not because of threat to the lawyers but because of the threat to the client and the risk that it may genuinely affect whether the client wins or loses.

Barry Melancon: Management also has a responsibility to reflect properly their financial information and has to wrestle with the issue as well as to appropriateness of presenting that liability or that contingency in the financial statements. So it is not just the two-legged auditor's CPA role. Under Sarbanes-Oxley, with very significant civil and criminal penalties, it's really a three-legged stool in that particular environment today.

Thomas Morgan: There is no question that these are very tough issues and this illustrates why we are here. As I say to students each year, it's dangerous to be a lawyer and I am sure the accountants say the same thing and as result there will continue to be these discussions.

Theresa Gabaldon: Speaking of penalties and what happens when you get things wrong, what kinds of sanctions might be applied against professionals?

Barry Melancon: Under Rule 102(e) of the SEC, an individual can be in effect disbarred from the SEC and not allowed to practice either permanently or for some period of time. Under the Sarbanes-Oxley Act, you can have penalties to the individual, you can have penalties to the firm. A firm could lose its ability to be registered with the PCAOB, which then means then it cannot do audits of public companies. Civil penalties to the firm can go up to $15 million. You have a whole set of state laws that come in to play, including the potential loss of the CPA's license.

Thomas Morgan: And all that is true for lawyers and in addition for both of us, liability to the company or to investors is a major threat to both professions.

Theresa Gabaldon: Barry and Tom, I would like to thank you both for the excellent discussion, I think we are just about out of time. I would also like to remind our audience that this fireside chat is archived on audio tape in the Society's virtual museum. The transcript of the chat will be ready soon.

I will be back as the moderator of the Fireside Chats in 2006 starting next March and I am pleased to announce that Pfizer, Inc. will help to sponsor the series. Our focus next year will be on the critical roles of the Internet and the business decision makers in the capital market system.

We will be welcoming such panelists as John Reed Stark, SEC's Chief of Internet Enforcement; Donald Langevoort of Georgetown Law Center, an expert on behavioral economics; and Don Blandin of the Investor Protection Trust, discussing how the 50 states have used Securities Litigation Settlement Fund to foster investor education. Please join us again next year on www.sechistorical.org. Thank you for being with us today.