Securities and Exchange Commission Historical Society
Oral History Project
Interview with Jerry D. Sullivan
Conducted on April 13, 2011, by James Stocker

JS: This is an interview for the SEC Historical Society's Virtual Museum and Archive on the history of financial regulation. My name is James Stocker. Today is April 13, 2011. I'm talking today with Jerry Sullivan. Good morning, Mr. Sullivan.

JDS: Good morning, James.

JS: Let's start at the beginning. Where were you born and where did you grow up?

JDS: I was born in Chicago, Illinois, and I grew up in Pittsburgh.

JS: Where did you go to college?

JDS: I went to undergraduate at Duquesne University, a B.S. in accounting.

JS: You knew from a very early age that you wanted to study accounting?

JDS: Yes, pretty much so. My father was an accountant, actually, a lawyer-accountant, and specialized in tax. I was more interested in the auditing area from the outset of my college career.

JS: Did you have brothers and sisters?

JDS: One brother and one sister.

JS: Did any of them become accountants?

JDS: Neither of them.

JS: So you're the one to follow in father's footsteps. What year did you graduate from Duquesne?

JDS: I graduated in 1956 and almost immediately thereafter joined Lybrand, Ross Brothers & Montgomery, the legacy firm for Coopers & Lybrand.

JS: You also managed to get a master's degree?

JDS: I was drafted into the service and wound up with the Army Audit Agency in Washington, DC. As a result, I decided to use my spare time to pick up my master's degree, which I had intended to do anyway, and succeeded in knocking that off during my army career, at George Washington University.

JS: How many years did you spend in the Army?

JDS: Two years.

JS: Two years? So that was from what year to what year?

JDS: 1957-58.

JS: Then in 1958, you joined Coopers & Lybrand?

JDS: Correct.

JS: Let's start at the beginning of your career. What kind of training did Coopers & Lybrand offer you?

JDS: Coopers conducted their first national training school, such as it was, in New York City. Phil Defliese, an old pioneer in the accounting profession, ran the school. It was conducted at NYU, and was an eight-week course in introductory auditing with Coopers at that time.

JS: How did what you learned there compare to what you had learned at university?

JDS: I believe that the orientation on how to actually perform auditing, and having access to actual records, created the bridge from the academic side to the practical side of getting after it and learning how to retrieve documents and audit them from an auditor’s perspective, rather than an academic perspective.

JS: You tell me you were interested in auditing from a very young age. What was it about auditing in particular that interested you so much?

JDS: You know, that's tough to answer. As a kid, you just don't know where you're headed, but I knew that I wanted to try auditing, and as I understood, it was a good framework of education to move onto other careers, if necessary.

JS: After your training at Coopers & Lybrand, where did you start? Where did a junior accountant start at this time?

JDS: As a junior accountant I started in the Pittsburgh office of Coopers and performed as a junior accountant on both large and small, mostly large, engagements at the time.

JS: What sorts of clients did you work on?

JDS: There was a five-and-ten chain, G. C. Murphy, registered on the New York Stock Exchange at the time; Alcoa; and a number of industrial companies in the Pittsburgh area, which were prevalent names at the time but have disappeared with the change in the economy of Pittsburgh and the nation.

JS: What was a typical audit like at that time? How did it differ from audits that are conducted today?

JDS: There was no risk assessment at the time. There was no framework of risk assessment. It was a matter of looking, for the most part, for random error in the financial statements, because everything was on a manual basis at the time.

JS: No computers.

JDS: No computers. The staff didn't even have hand-held calculators.

JS: So most of your work was digging through stacks of paper and performing calculations?

JDS: Yes, manual general ledgers.

JS: Did you rise through the ranks there in Pittsburgh?

JDS: Most of the ranks in Pittsburgh, from junior to senior, to supervisor, to manager, and became a partner in the Pittsburgh office.

JS: What year was that?

JDS: About 1964 or 1965, I made it in about five years, and transferred immediately to the Fort Wayne office of Lybrand. They had recently conducted a merger, and had a small office at the time, some fifteen to twenty people. The merged firm overwhelmed them in size and had quality control issues that had to be dealt with immediately. I transferred as a partner and a couple of managers transferred in from the Chicago office. We attempted to straighten the office out from a professional point of view.

JS: Did it need straightening out?

JDS: It did need straightening out.

JS: What sorts of issues did you have to work with there?

JDS: Sometimes as basic as observing physical inventories. Surprisingly for an office that size, it had a number of public companies.

JS: How big was the office? How many partners or staff were there?

JDS: At the time, Coopers probably only had eighty to a hundred partners nationwide. It was back in the infancy of the profession. Now you'll find that in a single practice office. There were five partners and a staff of about eighty to ninety.

JS: When did you become director of audit policy at Coopers & Lybrand?

JDS: I moved from Fort Wayne to the Columbus office of Coopers and assumed the role of SEC reviewer. I was the accounting and auditing expert for regional offices in the Columbus region. Columbus was a large office at the time for Coopers, and we controlled from an administrative and technical standpoint Cleveland, Dayton, Cincinnati, and Indianapolis.

JS: Had you done SEC work before that?

JDS: Yes.

JS: So you were already familiar with the different parts?

JDS: I was familiar.

JS: At that time was there an Auditing Standards Board?

JDS: There was an Auditing Standards Board.

JS: Did you use the different standards that got put out in your work?

JDS: Oh, absolutely. There was annual training on auditing issues, as well as accounting issues, and we received exposure drafts and in-office training on a timely basis concerning new standards.

JS: What does the job of director of audit policy involve? Or what did it involve at the time?

JDS: I assumed that role in a transfer from the Columbus office to the national office of Coopers in New York. As part of the national office, there were two divisions, technical divisions. One was the accounting side, and one was the auditing side. From the standpoint of director of auditing policy, I interpreted auditing standards as they arose or reinterpreted old standards if we found we needed some bolstering in technical advice to the field as a result of peer reviews or internal inspections.

I also embarked upon refreshing *Montgomery's Auditing* and assumed a role on the international accounting standards board of Coopers, which controlled the audit process on a worldwide basis for international engagements. So in combination, those were my duties, as well as assuming a role on the Auditing Standards Board.

JS: Did you also write comment letters in regards to exposure drafts and other issues?

JDS: Absolutely.

JS: So you knew the members of the Auditing Standards Board?

JDS: Yes.

JS: Who is represented on the Auditing Standards Board? How are members selected?

JDS: There were, in 1981 when I joined the board, still seven firms. They rotated a presence on the board. The board was fifteen members; it may have been twelve at the time. I don't recall specifically. The Big Seven/Big Eight rotated members on and off. They were on for a three-year period of time. They were elected for three years. The firms named whoever was to be appointed to the board. They went through an interview process. For the large firms, members were generally automatically accepted. The smaller firms, regional firms, or governmental representatives, there was maybe a more rigorous process of elimination. Those that survived the interview process went onto the board, once again for a three-year term.

JS: Who asked you to join the board? Was it someone within your company or was it someone from the AICPA?

JDS: Within the firm, the managing partner of the firm.

JS: This was basically a professional duty? You didn't see it really as an option as whether to join the board or not, or was it?

JDS: I was given the opportunity, but it was an opportunity that was tough to deny because it was an important role, both in the profession and for the firm itself.

JS: What were the major issues before the Auditing Standards Board when you joined it?

JDS: Probably the most controversial and difficult issue at the time was the emergence of SAS 39, auditing sampling. It was quite controversial within the profession. There were those that were more orientated towards statistical sampling and those firms that were more orientated towards judgmental sampling, Coopers being on the judgmental side. In reality, as that standard came on line, it was done without a framework, without the SAS on audit materiality and audit risk.

JS: Which came later.

JDS: The other element of it is that the orientation was more towards seeking out random error in financial statements. As the computer emerged and became more important in the financial reporting process, systemic error was a problem. Sampling just became less important as a topic, maybe more important to academicians at the time but certainly not to professionals, because even those firms that represented a statistical orientation to the public, when you looked at their audits, they were basically judgmental audits, except in rare circumstances.

JS: In the early 1980s, the use of computers in accounting had already impacted the auditors?

JDS: It was just beginning to in a very meaningful fashion. We had punch cards, of course, before then, but the computer itself and the decentralization of the computer into microcomputers and everybody having a microcomputer at their desk was just emerging as a business issue, as well as an auditing issue.

JS: Was the work of auditors on the public radar to any degree at this time, the way it became later during the 1990s and, of course, the early 2000s?

JDS: It was very important during the mid-to-late eighties. That was the time where the profession started to undergo a lot of criticism in the financial and general press. There was a series of articles in the *Wall Street Journal*, as well as the *New York Times* criticizing the audit process. Congress held hearings.

JS: Even before that, the Auditing Standards Board was itself considering many different issues related to the basic audit model. For instance, in 1983 the ASB established a levels of assurance task force. What was that about?

JDS: The Auditing Standards Board took on the expectation gap and created a framework of ten standards that were to be issued to deal with this expectation gap that regulators were focused on, legislators were focused on, and the financial press was focused on. That was one element of the profession's reaction to criticism at the time, and probably the most important.

JS: In 1985, you became chairman of the special task force on audits of repurchase securities transaction?

JDS: Yes.

JS: What did that committee do?

JDS: Basically, we tried to understand just what securities transactions and repurchase agreements were. We had no idea, nor did the FASB, because we kind of worked together in some fashion on the project, and drew in people from industry as well as the governmental sector, to try and deal with the issue of repurchase agreements, understand them, and what their audit implications were.

JS: They were a relatively new development at this time?

JDS: That was certainly a new development at the time.

JS: About that time you also took over the chairmanship of the ASB?

JDS: Yes, I did.

JS: How did that happen? Who asked you to do this?

JDS: The chairman of the AICPA.

JS: And was that going to involve significantly more of your time?

JDS: Yes, it did. It probably ratcheted up my time on auditing standards to at least 50 percent of my time, when you took into consideration the speaking engagements that were involved, and the interactions with FASB and the SEC that occurred as a result of the chairmanship.

JS: As you mentioned earlier, around the mid-1980s was also the time that auditing began to register on the national radar. For instance, in 1985, Representative John Dingell began holding hearings on the accounting industry.

JDS: That's correct, and I testified at those hearings.

JS: What was the Congress interested in hearing about?

JDS: You'd have to ask the Congress on that, because they put on quite a show. What we tried to do is let them understand what audit issues the profession saw as real issues to be dealt with by the profession, and how we were approaching those issues in terms of elevating the audit requirements and standards.

JS: Did you find that the Congress was very well informed about the issues, or were they just making a lot of noise?

JDS: They were informed at the staff level. They had good staff-level people. They understood, and we had meetings with those staff-level people to inform them as to what the issues were from our perspective, and how we were dealing with the issues. They had access to the financial press and lobbyists, and that's where the middle ground met and we dealt with the issues. The hearings themselves were more of a formality.

JS: Did the ASB interact with the SEC at all during this period?

JDS: Absolutely. We had at least bimonthly meetings with the SEC's chief accountant's staff. They identified issues that we should deal with or they thought we should deal with. They attended meetings of the ASB and in some cases meetings of the task forces that were working on issues, so that they could provide their input at our more formal meetings with the chief accountant.

JS: Did they tend to offer very specific suggestions as to how they wanted certain issues resolved?

JDS: Not so much at the issue level, unless they took exception to one or more specific matters we were dealing with, but that was very, very seldom. They were more in the position of identifying matters that they observed in the registration process and the enforcement process, that they thought possibly auditing standards needed to deal with or improve audit guidance with respect to those issues.

JS: During this period, you were also a member of the advisory council of the National Commission on Fraudulent Financial Reporting, which was also called the Treadway Commission. Why was this commission formed?

JDS: Once again, it dovetails into the criticism in the financial press of the auditing profession and Congressional focus. There were audit failures occurring and fraudulent financial reporting that occurred. There was a lack of understanding as to what the auditor's responsibility was, with respect to fraudulent financial reporting, even within the profession, among professionals. There's still, in my judgment, an inconsistency in standards and reporting with respect to what the auditor is and is not responsible for.

JS: What did you do as part of the advisory council? Did you send letters in, or just how did you consult with the commission?

JDS: There were meetings of the advisor with the commission itself, commission members, information sessions where we informed them at a very detailed level of what the profession was doing at the time to deal with financial reporting, both directly and indirectly. We were trying to provide them an insight as to what the profession was doing to react to the criticism related to their inability to detect fraudulent financial reporting on a routine basis.

JS: This is a number of years ago so I don't know whether you remember the report or not, but do you remember it, and what did you think of it?

JDS: I thought it was an excellent report.

JS: Some people did criticize the report as not going far enough. Do you think there were any pressures on the board to limit its findings?

JDS: I'm sure there's always pressures to limit findings, both from the Financial Executives Institute and others. That's just part of human nature and our society. I thought they did a good job. I thought they did a very good job.

JS: One of the panel's recommendations was that the ASB be reorganized into a body where half the members were knowledgeable about accounting, but not actually engaged in public accounting. Why would they suggest that?

JDS: My recollection is they thought that that would bring an outside perspective to users of financial statements and the users of audit perspective to the setting of standards. That didn't go anywhere with the board. We thought very strongly at the time, the leadership of the firms, the Institute, and the Auditing Standards Board itself that it took real technical expertise to deal with auditing issues. We'd react to identifying auditing issues by a broader group and did so, but in terms of creating the standards and the limitations of the auditors' ability to detect fraud we just felt that it wasn't a reasonable solution.

JS: What impact did the Savings and Loan Crisis have on the auditing profession?

JDS: Once again, it was a basis for significant criticism of the auditors' role or lack of role in preventing the S&L debacle. We worked once again and met with regularity with the comptroller of the currency and the Fed to determine whether or not we were missing something or what their reaction was and how they were dealing with the crisis. But in terms of auditing standards, it had very little impact on the creation of auditing standards.

JS: On Valentine's Day in 1987, the ASB released an exposure draft with ten different steps that would address the so-called expectations gap between financial statement users and CPAs. What sorts of standards were these?

JDS: This is probably as good… [*hands over an article*]

JS: So we have here a document on the expectation gaps in auditing standards. That's very nice. It has an overview of the ASB's nine standards. So what was the expectation gap? Can you tell me about that?

JDS: It went back to the Congressional and legislative criticism of the profession, the financial press criticism of the profession, in terms of the ability to detect fraud. Whether or not the auditor was communicating in a fashion that made sense to the users of financial statements and to those with oversight responsibilities, such as audit committees, and whether or not from a broader perspective we were dealing with issues that the public and the critics of the profession could understand, in a way that they understood that we were attempting to deal with the problem of fraudulent financial reporting and explaining how we were dealing with that problem in an open and understandable way, even leading to a revision of the auditors' report.

JS: In which way was the auditor's report changed?

JDS: Well, in the most simplistic terms, it went from a two-paragraph report to a three-paragraph report. It made clear that management had a responsibility for the financial statements. That was, believe it or not, at the time, not necessarily understood by legislators. It wasn't understood completely by those in the court system that were evaluating the quality of audits.

So we made it clear that management had a responsibility for the financial statements and that our responsibility was to audit and provide reasonable assurance they were free of material misstatement. That material misstatement was the same for error and fraud.

JS: Many within the auditing profession seemed to think that management and Congress and many other people were shifting the responsibility from management to the auditors themselves?

JDS: That's right.

JS: What new obligations were imposed on auditors in terms of communicating with audit committees?

JDS: The most significant change was that the auditor did have to report in certain matters to the audit committee as a part of the audit process, so that they were at least informed as to what the auditor observed in terms of critical areas, risk areas, and concerns that might be reached by the auditor during the audit process, so that they weren't tampered down by management. We got to those that had oversight responsibility.

Just as importantly, the auditors' role with respect to evaluating internal controls was significantly expanded and embraced. The auditor had a mentality at that time that you either relied on controls or you didn't rely on controls. If you didn't rely on controls, you didn't have to do any work with respect with the internal control system of an entity.

Small practitioners and those who were involved with companies that were not public opted out and did no control evaluation, or at least said that they did none. Now it's impossible to perform an audit without understanding and evaluating controls. There were those that said they didn't evaluate controls, for example, yet observed physical inventory, which is a control. They confirmed receivables from the receivable listing provided by the client.

They were relying on controls, but not acknowledging it. If you pulled in the risk assessment process of where an audit can go wrong, it's the controls over the financial reporting process that are built into the accounting system, particularly with the emergence of the computerized systems around the world.

It became an auditors' responsibility as a result of these expectation gap standards to understand the internal control system of a client, in order to perform substantive tests and to test controls where efficient and effective to do so. That was a major step forward.

At the same time, the auditor distinguished what should be reported to management and the audit committee. It went from "material weakness" to "reportable conditions." Now, at the time, we actually came close to eliminating the concept of material weakness and had the backing of the chief accountant to do so. But we couldn't move the profession that quickly. We just couldn't get it done.

The feeling among many of us was that controls in modern-day systems are not measurable in terms that they will create x number of errors in the financial statements. For example, a public company without an audit committee, it's very difficult to evaluate the materiality of that lack of an audit committee on the financial statements. Yet that's a very significant weakness and would be a reportable condition. It would significantly impact the financial reporting process. We wanted to move towards the concept of reportable condition and did so, and required that reportable conditions be reported to the audit committee as one of the ten matters that needed to be reported as part of the audit process.

JS: Just a moment ago you said that there was some resistance within the accounting profession to some of the reforms that you wanted to implement. What was their main concern? Was it cost? Obviously many of the measures that you mentioned would require a great deal more work from the accounting profession, which in turn increases the amount of hours that they have to spend on a project and increases the overall cost to the client.

JDS: It's not only cost, it's the legal liability exposure, which is an indirect cost.

JS: Absolutely.

JDS: But nonetheless, the attorneys were very, very cognizant of where we were moving with the expectation gap and were very concerned, and formed committees to evaluate the standard-setting process as it related to the expectation gap. There was a pressure of not only more costly audits directly, but more costly defensive audits.

JS: Of course, litigation became a major issue during this period, right?

JDS: Absolutely.

JS: I'd definitely like to ask you some more questions about that a little bit later, but first, just to move on to the Public Oversight Board. In March 1989, you became Executive Director of the POB?

JDS: That's correct.

JS: How did you move on to this position from your job at Coopers & Lybrand?

JDS: When I embarked upon the role of director of audit policy, it was intended to be a five-year rotation in and out. It didn't work that way on a practical front, because I wound up with the Auditing Standards Board for six to seven years. (Laughter.) I wound up on the international firm's Auditing and Accounting Standards Board for a similar period of time. I was working on *Montgomery's Auditing*, and until the expectation gaps standards were resolved, it just wasn't practical for me to move along and me to be replaced rotation-wise with somebody else. Keeping the process fresh as possible was the objective within the firm, and most firms at that time.

When I completed that process, I had to turn to what was next for me. It would be maybe a managing partner of an office. That's a largely administrative role and I may have been good at it or may not have been good at it, but that isn't where my interest lied. I was more on the technical side of auditing and decided I didn't want to reemerge as an engagement partner on large engagements. I'd gone that route before.

I thought as a practical matter, anything I did within the profession, within Coopers, would be somewhat repetitive of what I've done in the past. I decided to try new challenges. I met with the managing partner of the firm over a year's period of time, and he tried to convince me to stay on with the firm. I convinced him that, really, I needed to try something fresh. He, Pete Scanlon, at the time, was a catalyst to introducing me to the chairman of the POB and ultimately meeting with the board itself and concluding that that was an option from a career standpoint that I was interested in pursuing.

JS: Who was chairman at that time?

JDS: Al Sommer.

JS: So you knew him before you took the position at the POB?

JDS: Oh, yes. Al was a wonderful person. A real politician, understood how the process worked, understood auditing, understood the profession and the regulatory side, having been an SEC commissioner. I think the world of Al.

JS: He had served as chairman since the creation of the POB?

JDS: Since the creation of the POB.

JS: So, over the years of working on the Auditing Standards Board, were you directly exposed to the work at the POB, or was that operating completely separately?

JDS: That was pretty separate. It was the SEC Practice Section, and they did their own thing and ran the peer review program and the QCIC process. We were pretty separate from that, other than getting feedback from the SECPS as to what issues they observed.

JS: So what were your duties as the executive director of the staff there?

JDS: We had a memorandum of understanding. I'm sure you're familiar with that. It indicated the role the POB would play, and the role that the SEC and AICPA and the member firms would play, in terms of funding us and having access to our records and us having access to their records and meetings. That memorandum was pretty well set forth in writing. As a practical matter, the SEC staff attended some meetings of the board. The board met with the SEC staff. The SEC staff came to our office at least quarterly to review audit work papers that we produced with respect to the peer review process and the QCIC process.

JS: Overseeing the peer review process was one of the major duties of the Public Oversight Board.

JDS: One of the two major duties. The other major duty, of course, was the QCIC process, evaluation of alleged audit failures.

JS: How did you oversee the peer review process? Did you go in and look at the actual documents that were being produced and assess them, or how did that work?

JDS: Well, first, we had a historical record of what the last peer review entailed, what the problems were. We were actively engaged in the planning of the new peer review, in terms of industries selected, offices selected, engagement partners selected, and the scope of the planning process in terms of the number of hours involved in –

JS: In the peer review?

JDS: Yes. So we were deeply involved with the peer-reviewing firms in setting the process in place, planning the peer review. We oversaw the peer review field visits, both to the national offices and to the audit performing offices, the field offices. We would go in and review engagements as well as the peer reviewers. I'd find that our findings were consistent with theirs, or if they weren't, why they weren't. It was a pretty intensive oversight of the peer review process. Then evaluating the results of the peer review, in terms of identifying issues and whether those issues grow to a letter of comment level or whether they led to a qualification or a clean opinion.

JS: You said that the Public Oversight Board was working on developing a new model for a peer review at this time?

JDS: No.

JS: Okay, no, I'm sorry, then I misunderstood you a little bit earlier. Was everyone generally satisfied with the existing model of the peer review?

JDS: The SEC was satisfied. They put reliance on it and indicated so in their annual report to Congress. The profession was happy with it. There was obviously tension among POB staff and the firms in the conduct of the peer review process, because we were overseeing them. There is natural tension, but nothing that was all that significant in terms of there being out and out warfare between the POB and the firms themselves. There were disagreements on specific matters that were resolved in a professional manner. From the standpoint of peer review, I think the heaviest critics at the time were the academicians. They felt that the self-regulatory process was fatally flawed to begin with, that you can't have firms reviewing other firms and have an objective result.

JS: Did the POB interact with academia at this time? Did you have joint conferences?

JDS: Yes, we did.

JS: Tell me about the QCIC process. What was that and how did you oversee it?

JDS: The QCIC process was a requirement on the audit of any SEC firm, by members of the SEC Practice Section, where there was an allegation of an audit failure by either regulators or the civil court process. The QCIC process started with one of the firms or many of the firms, as a practical matter, receiving a complaint of an alleged audit failure. That complaint, whether it be a civil document from the court system or from a regulator, had to be provided to the POB, the SEC Practice Section, and the QCIC committee, within thirty days of its receipt. So we were looking at the complaint while it was alive in the court or regulatory system.

The AICPA staff assigned a staff member from the QCIC staff to evaluate and write up the issues pertaining to what were possible audit issues and audit failures that might be addressed. The intent, of course, was not to determine whether that specific audit was a failure or not. The court system and the regulators ultimately determine that. It was to determine if the issue was something that should be addressed by auditing standards, should be addressed by the quality control system of the firm, or should be addressed in terms of evaluating the performance of the engagement partner.

JS: Did you have any disciplinary authority, any power to assign punishments?

JDS: In a sense, yes. If the findings were such that we believed that the firm needed to improve their quality control system in a given area, we oversaw that improvement and were satisfied that it fit and took place and was a professional response to the issue we identified.

If the engagement partner was believed to be at fault, we had three powers, or the firm could respond in one of three ways, to our criticism and individual performance. They could remove the partner from the engagement and any SEC engagement in the future. They could terminate the partner, which very seldom, if ever, occurred, because they needed the partner in the legal defense system within the firm. That would be an out and out blatant thing, "Hey, this guy didn't perform." That, as a practical matter, didn't occur very often. The third was that, rather than remove the individual from audit engagements, SEC engagements, that they had to have heavy supervision, like the assignment of other partners to observe their work. So those were the penalties that we could impose.

JS: In practice, did that happen very often?

JDS: Sure.

JS: More than a few times a year, then?

JDS: Yes. The QCIC process evolved into a process where as many as fifty engagements a year were evaluated. It was a very time-consuming process that resulted in significant interviews with the firms, inspection of work papers, and interviews with the engagement partner. It was from my standpoint a very meaningful and important process in identifying professional issues within the profession that could be improved.

JS: How many staff members did the POB have at this time?

JDS: It had five permanent staff members, and we had others that assisted us as the need arose.

JS: It's still a relatively small number to oversee the entire auditing profession.

JDS: Absolutely.

JS: In 1990, the AICPA decided to require membership in the SECPS for all firms that were auditing SEC registrants.

JDS: That's correct.

JS: How did that change the nature of the POB's work?

JDS: It increased the number of firms that joined the section. At its peak, we had 1300 member firms. That boiled down to a peer review every three years. Some of the member firms didn't have SEC engagements, so we considered them low-risk engagements and didn't oversee the peer review process, related to them. We built a databank of those firms that had had or were having problems as a result of QCIC process or identification of prior peer reviews or inspection programs within the firm itself. We performed a risk assessment. Obviously, we reviewed each of the large firms. When I say large firms, probably the twelve to fifteen largest firms, which maybe had 80 percent of the SEC engagements.

JS: Did you add on more staff during this period, or after 1990, when all these new firms joined?

JDS: The new firms joining didn't add to our workload all that significantly, because those that were brought in had very limited SEC engagement, maybe only one engagement. While we performed a sample that made a selection through the risk process, those peer reviews were very short, because we were focused on the public company sector, and they may have only had one public company.

JS: One interesting thing, when you go back and read these annual reports from the POB, is that there's usually a section that comments about the POB's work itself. It talks about the oversight of the peer review process and the QCIC process and the other official duties that the POB had. But then there also tends to be a section where the board comments about the status of the profession as a whole.

JDS: Yes.

JS: Obviously, the POB was concerned about more than just these specific mandated oversight processes. One of the issues that the POB seemed to be concerned about in the early nineties was litigation. What was happening with the accounting profession in terms of litigation at this time?

JDS: Litigation was getting a lot more press. The accounting profession being a topic in the financial press had emerged in the mid-to-late eighties to the nineties as a very hot topic and readable topic within the *Wall Street Journal* and *New York Times* and other publications around the country. It was getting a visibility that it hadn't really had in the past. I think the board focused on that from the standpoint that there is an expectation there as a result of this focus on the profession that needed to be dealt with. Are our standards as good as they should be? Is the profession communicating its role in a meaningful and complete fashion? Is it interacting with the SEC and with Congress in a meaningful way?

JS: What were some of the options for dealing with that problem of litigation? For instance, in the 1992 POB annual report the board offered a suggestion that an organization be created along the lines of the National Transportation Safety Board for the auditing industry, a board that could look into failed audits, where there had been problems, without creating liabilities for the firms involved.

JDS: That was a recommendation of the board, correct, that never went anywhere, because quite frankly the profession couldn't find a way to overcome the legal hurdles with respect to it. The feeling was that the QCIC process was really a legal hurdle in itself, in that it could be accessed by plaintiff's bar to bring pressure on the audit process and identify areas that might have been an audit failure. If we identified corrective actions that the firm had to take with respect to the engagement partner for a quality control system, and if the plaintiff's bar had those same issues identified, it could result in significant legal liability. We protected our product from the legal process and just formed the National Transportation Safety Board. We created an organization that would have to withstand those challenges on a much more visible level to the plaintiff's bar.

JS: In 1993, the POB put out a report called “In the Public Interest.” What was that report trying to address? One of the things the report talked about was the loss of public confidence in the accounting profession as a result of its role in the S&L crisis.

JDS: It was hammering on the same thing, that the profession from the user side wasn't performing in a way that avoided criticism and creating a response from the informed public that said, "Hey, it's not the auditors' fault. It's management's fault." What else can I say?

JS: Exactly. Do you remember how this report was received publicly? I think that there was a little bit of criticism of the report. For instance, the *New York Times* called it a “modest” auditing proposal. But the AICPA did support it publicly.

JDS: They did support it publicly. Once again, the financial press was on the profession at the time, and I doubt if anything that would have been written at the time would have satisfied the critics. I thought it was a very thoughtful response. It went deep into the interview process with the firms and with the professional leaders, both in the profession and outside the profession. Those involved from the POB I think were high quality individuals.

JS: It made a number of recommendations to many different actors that were involved in auditing or in the oversight of auditing. One interesting recommendation was one that it made to the FASB. It recommended that the FASB undertake a study of the possibility of changing from historical cost to fair value cost in accounting standards. Why was the POB commenting on financial accounting standards issues? What did the POB think about this?

JDS: The feeling among the board members, or at least the majority of the board members at the time, was that the historical cost was not portraying in the basic financial statements a net realizable value of assets and liabilities on the balance sheet. Therefore it distorted not only the balance sheet, but the income statement. Until that more basic problem could be resolved, there would be an expectation with respect to the audits of historical cost that were unrealistic, in some board members' minds.

JS: How much was the POB staff working on these reports, or was this something that the board was writing itself mostly?

JDS: This particular report was spearheaded by Don Kirk, a board member. Don wrote most of the report with Ralph Saul.

JS: There was another panel formed around this time, in 1994, that looked into the issue of auditor independence. It was responding to criticism of the chief accountant of the SEC, who was Walter Schuetze at this time. Then the panel issued a report entitled "Strengthening the Professionalism of the Independent Auditor." This may have been the report that Don Kirk and Ralph Saul were involved in.

JDS: That's right.

JS: There were a lot of different reports during this period, obviously. The panel concluded that at that time there was not any need for additional rules, regulations, or legislation dealing with conflict of interest. What were the major concerns about the issue of accounting independence at this time?

JDS: Scope of services was certainly an issue that was emerging at the time and becoming more significant day by day. From my perspective, that was a real focal point, that the auditors were becoming embedded in other services that didn't require independence and that the audit process as a result was in the public eye as eroding into something other than a truly independent process.

JS: Tell me about the Independence Standards Board? What was that and why was it created?

JDS: You'd have to ask the AICPA why it was created, but from my perspective it was to establish rules for the auditing firms to comply with the public perception of a failure to have independence with respect to attest engagements.

JS: Was the POB involved in the negotiations that led to the creation of the ISB?

JDS: No, not directly.

JS: How did the POB come to form the panel on audit effectiveness in 1998, the O'Malley Commission?

JDS: Once again, there was criticism of the audit process, continuing criticism. I think the real spark for that was the SEC Chief Accountant, who at the time believed that the audit process needed to be improved substantially.

JS: This was Lynn Turner?

JDS: Yes.

JS: Did you have much contact with him while you were at the POB?

JDS: A fair amount, yes.

JS: How did the committee go about looking for members to join this panel?

JDS: Well, there was a consultation among board members, among myself and the SEC commissioner at the time, Arthur Levitt, and the AICPA. Everybody got their oar in the water with respect to possible candidates, and Al Sommer eventually named, through negotiation, who the members should be.

JS: Around this time, was there any concern about the POB's possible continuation?

JDS: Not at that time, no.

JS: Okay, so this was prior to that? In 1999, Charles Bowsher became the chairman of the POB and Don Kirk became the vice chair?

JDS: That's correct.

JS: Was there any hope that these gentlemen, who were relatively high-profile individuals at the time that they could help turn around the fortunes of the POB, because it was coming under a lot of criticism at this time?

JDS: It was beginning to come under criticism, certainly that was the period in which the criticism emerged. Bowsher was named because he was high profile and he had the backing and had a very close relationship with Mel Laird, who was the ultimate politician, both in and out of the profession. Those two working in concert, I think, resulted in Chuck being named chairman.

JS: Did any of this criticism interfere with the oversight work? Did it have any impact on the peer review process or the QCIC process? Or did that just continue apace?

JDS: That continued somewhat unabated until the Enron crisis.

JS: That was sort of the turning point. But then in 2001, in July, the POB announced an agreement on a new charter that intended to implement some of the O'Malley Panel's recommendations. Was the O'Malley Panel the major driving factor behind this new charter?

JDS: No, Chuck Bowsher was the major driver behind the charter.

JS: What changes did the charter make?

JDS: From a practical matter, I don't think it made any changes, because by the time it would have become effective in a meaningful way the POB dissolved.

JS: Did you offer input into the drafting of the charter or did the board just come to you with it?

JDS: It was handled principally by legal counsel of the board and Chuck himself. Now, board members had modest input to it, and the staff did as well.

JS: The new charter expanded oversight over the Auditing Standards Board and the Independence Standards Board?

JDS: Actually, we had that oversight responsibility at the time, before the new charter was entered into. But that was a late oversight responsibility. We took on oversight of the Independence Standards Board when the board was formed, and it was not a result of the charter. We assumed responsibility for the oversight of the Auditing Standards Board before the charter was finalized, as well.

JS: Did the SEC offer any input into the creation of the new charter?

JDS: Not directly. Now, I'm sure Lynn Turner provided specific input himself to Chuck Bowsher, but not through the formal board process.

JS: So how did the POB respond to some of big accounting crises at this time? For instance, we can go back to Waste Management, even. When this scandal came out, did the POB start investigations into the process?

JDS: It started investigations vis-à-vis the QCIC process, and identified or looked for issues that might have impacted on the quality control system of Arthur Andersen itself. It also evaluated the quality of work through the QCIC process, and that was a risk factor that drove the selection of certain engagements in the subsequent peer review. So, yes, it had involvement.

JS: Did you feel like you had the staff necessary to do this, because obviously these were massive cases?

JDS: Once again, you have got to recall that we oversaw the peer review process and the QCIC process. The firms themselves engaged in the actual peer reviews. Our job was to see that that they were conducted with independence and were complete and were fair.

JS: Were there any concerns about how the process was being conducted at this time?

JDS: There was always a concern that it was one professional patting the other professional on the back. That was always a criticism, and it was quite prevalent, as I said before, in the academic circles.

JS: With Waste Management or WorldCom or Enron, when these issues came up, did you specifically look at those audits and draw them up and look at them?

JDS: As part of the QCIC process, yes.

JS: I'm not sure if you'd like to talk about that at all, but do you recall what some of the conclusions were?

JDS: I can't recall specific conclusions other than Enron.

JS: I did see that, in the case of Enron, that Deloitte did a peer review of Andersen at the end of 2001 and it gave the company a clean bill of health, but it was not allowed to look at Enron. When the SEC was investigating a case, did it still go through the QCIC process, if the SEC was investigating?

JDS: Yes.

JS: There was no conflict between the two processes? They occurred simultaneously?

JDS: There was always concern that the findings of the QCIC process would lead into an SEC investigation in the matter, and that we would be a conduit to providing the SEC with information about the engagement. But we had to deal with that at a practical level, and if that's what occurred, that's what occurred.

JS: Do you remember your reaction when you heard about Enron?

JDS: Yes, I was appalled.

JS: Did you worry that it might have some ramifications for the self-regulation of the industry?

JDS: Certainly, and at the time we were focused on Arthur Andersen and conducted a mini-review of their audit of that particular industry, selecting other clients within the industry to see whether or not there were similar problems. We conducted kind of a special investigation of Arthur Andersen at the time, as it relates to Enron's industry.

JS: Did anyone think that this might result in a suggestion from the SEC for a new panel that would replace the POB?

JDS: Not really, no.

JS: Or was there an expectation that you would be consulted before that happened?

JDS: You're dealing with matters that are personally sensitive to a number of people and would be critical of specific people, so I hesitate.

JS: I can certainly understand that. If you don't feel like commenting on that, you're certainly not obligated to. Did the board members consult with the staff before they decided to tender their resignations?

JDS: Yes.

JS: So you remember when you heard about this?

JDS: I was in the room when it occurred.

JS: Was there any attempt to talk with the SEC before the board members decided to resign and to try to negotiate some sort of a way out of the situation?

JDS: Once again, individual board members might have had different reactions than other board members. I'm not comfortable dealing with the specifics.

JS: After the board announced its resignation, they nonetheless decided to issue a white paper on their view of how accounting regulation could be improved. Did the staff contribute to the white paper?

JDS: Yes.

JS: So how were plans for a transition period formed?

JDS: Well, the POB had resigned, so there was no POB. There was a POB staff. It was going to take time for the PCAOB to emerge and become a meaningful body of oversight and a creator of auditing standards. It was felt that the profession had an obligation to the public to continue its self-regulatory programs until such time that they were either needing to be revised or replaced by the new board.

JS: So there was a memo of understanding between the SEC and the AICPA, the SEC Practice Section, and some of the accounting firms for your role?

JDS: As a practical matter, the chairman of the SEC Practice Section, Bob Herdman, who was the chief accountant at the time, and myself had a meeting where it was determined it was in the best interest of everybody that the oversight of the POB continue in some fashion during the transition period. As a result, it was agreed that I should create a transition oversight board and perform the duties of the old POB in terms of oversight of the QCIC process, auditing standards process.

JS: To make sure that oversight would continue.

JDS: Exactly.

JS: Was this before or after the Sarbanes–Oxley law was passed?

JDS: It was after the Sarbanes-Oxley, almost simultaneous.

JS: Everything was going on at the same time.

JDS: Exactly.

JS: Were you asked to offer any input into the process that led to Sarbanes-Oxley?

JDS: No.

JS: So there was no testimony before Congress?

JDS: No testimony before Congress, in fact, none by any POB member.

JS: Did the SEC ask for that?

JDS: I think tensions were strong enough at the time that –

JS: – that would've prevented that?

JDS: Right.

JS: So it was a bit of a challenge for the SEC under Harvey Pitt to find board members for the PCAOB, wasn't it?

JDS: Yes, it was.

JS: Was the transition oversight staff asked to help out with the search?

JDS: No, as a matter of fact, there was a sensitivity that any involvement POB members had or staff members had would be kind of "tainted," because it would be a carrying on of the old, rather than the creation of an independent new. Other than meetings with the board members themselves after they were named by myself, there was no interaction.

JS: Did you have to train the new staff members for the PCAOB?

JDS: Absolutely not.

JS: Okay, but they were already coming on line while you were still there, right?

JDS: They were coming on line, but of course George Diacont was named, and he subsequently hired members that had been involved, or staff members of the new PCAOB that had been involved in the peer review process. They had a running start in knowledge of what the profession was doing and how they could move that forward under the new board.

JS: Did the POB turn over their files to the PCAOB?

JDS: No.

JS: There was no request for that?

JDS: No. I think that the posture of the new board was that they didn't want to be influenced by a body that had been highly criticized in the financial press and the conflict with the SEC and regulators at the time.

JS: Maybe I shouldn't even ask this question, but were you asked to stay on under the new board?

JDS: As a staff member of the board?

JS: Yes.

JDS: No, I was tainted.

JS: Well, that happens. So you stayed on through the end of 2003?

JDS: That's correct.

JS: What did you do from there, professionally?

JDS: From that point on, I've been involved in evaluating litigation as an expert.

JS: Do you miss the days of overseeing the auditing profession?

JDS: No, I enjoyed it at the time, and time goes on, and I'm enjoying doing what I'm doing.

JS: I thought we'd finish up with a couple of general questions. First, I'd like to go back to the subject of *Montgomery's Auditing*. Can you tell me about working on that work?

JDS: We had a previous edition, a ninth edition, and had gone completely stale. It was published in the early sixties, and we were still kind of a smokestack country in terms of what the auditing process involved, making widgets and passing them on to the third party. Also, the audit processes of the firms had become much more imaginative, let me put it that way. We felt that we needed to capture how the audit process worked in the eighties, with the emergence of computers and the fact that one type of audit didn't fit all, and the fact that old *Montgomery's Auditing* dealt with accounting standards, as well as auditing standards, and accounting standards had grown like Topsy. How you fit both in the same book was from my point of view totally impractical.

So the first move was to make a decision that we would not deal with accounting principles, we'd deal with the audit process solely. Secondly, we would deal with what I called industry chapters and how we approach the advertising of the health care industry, as opposed to making widgets. Then we went about writing.

JS: How many years did it take you to come up with the new edition?

JDS: From inception to publication, about five years.

JS: Did you have research assistants working with you on this project?

JDS: Hank Jaenicke primarily.

JS: Outstanding. Have any new editions come out since then?

JDS: Yes, there have been, but like most textbooks today, it's online.

JS: Overall, how do you feel about the SEC's role in overseeing the auditing profession? Do you think it works pretty effectively with the different boards you worked on, with the ASB, with the POB?

JDS: I think it worked extremely well, up until around 2000. Then I think there were growing tensions on both sides that made a working relationship problematical at best.

JS: Do you care to offer any thoughts or observations on the functioning of the PCAOB since it took over?

JDS: Not really.

JS: Any final thoughts, looking back on your career?

JDS: Well, I don't think so. It's been an interesting career, but I'm pleased with my participation in the process, both in the profession and with the firm of Coopers, and I'm kind of a happy man.

JS: Well, thank you very much, Mr. Sullivan.

JDS: Thank you.

[End of Interview]