

accounting club
beta alpha psi
second annual conference



ACCOUNTING :

**A Glimpse
Into The
Future**

january 12, 1979
sheraton-waikiki hotel
honolulu, hawaii

TABLE OF CONTENTS

Opening Remarks	
Earl Fry, Accounting Club President	1
Letters of Appreciation	
Governor George R. Ariyoshi	3
Mayor Frank F. Fasi	4
Compilation & Review of Financial Statements	
William R. Gregory	5
The Impact of Current Events on Future Accounting & Auditing	
Edwin M. Lamb	15
The Foreign Corrupt Practices Act - The Increasing Role of the Internal Auditor	
Kenneth P. Johnson	28
Federal Regulation of the Accounting Profession	
Sam Yellen	41
The Future Impact of the Revolutionary Changes in Computer Technology on the Accounting Profession	
Herbert H. Isaacs	49

"ACCOUNTING: A GLIMPSE INTO THE FUTURE III" is scheduled for January 11 & 12, 1980. It will be a two-day affair; again featuring national leaders of our profession speaking on current and future topics in accounting.

WE HOPE TO SEE YOU THERE.

OPENING REMARKS

EARL FRY

President,
University of Hawaii Accounting Club

Good morning. I'm Earl Fry. The University of Hawaii Accounting Club and Beta Alpha Psi welcomes you to the second annual conference, "Accounting: A Glimpse Into The Future."

This series of conferences was borne in the fall of 1977 out of our recognition of two urgent needs. The first need pertained to the delays in receiving current information on recent developments in the accounting profession. Being isolated from the mainland, Hawaii's professionals were often denied the privilege of being included in discussions of current developments in accounting with national experts. The second need relates to the unfulfilled needs of university students. As students we are told that the learning process never ends, that we are expected to keep ourselves abreast of changes by attending professional seminars and conferences. But as students we never get to experience or attend these professional development seminars and conferences, and this is where the action is.

Out of these two needs was spawned the concept of an updating conference which would be beneficial to practicing professionals as well as developing students.

The result is this conference, "Accounting: A Glimpse Into The Future," sponsored by the Accounting Club and Beta Alpha Psi, with three purposes in mind.

First, this conference is designed to give Hawaii's accountants an opportunity to listen to and discuss, with nationally recognized speakers, the current, pending, and future developments in accounting and auditing, both in principle and in practice.

Second, this conference enables students to broaden their academic horizons by giving them an opportunity to witness, participate in, and experience the dynamism and growth of the accounting profession.

And third, this conference is designed to bring professionals and students together for a mutually beneficial exchange of thoughts and ideas, with the intent of fostering increased interaction between professional accountants and

aspiring professionals.

With this in mind, our conference coordinators and committee members have put together a timely program of prominent, top-notch speakers, addressing the subjects shown in your program.

Thus, what was just an idea two years ago, has blossomed into these series of annual conferences which we are sure you will find both vitalizing and enlightening.



EXECUTIVE CHAMBERS
HONOLULU

GEORGE R. ARIYOSHI
GOVERNOR

January 9, 1979

To the Officers and Members
Accounting Club and Beta Alpha Psi
University of Hawaii
2404 Maile Way
Honolulu, Hawaii 96822

Dear Students:


Your pioneering work in 1978 and this year in sponsoring professional-level conferences with distinguished Mainland specialists in accounting as guest speakers has been a noteworthy accomplishment. I wish to extend to you my congratulations on your initiative and skill as you prepare for the second conference to be held at the Sheraton Waikiki Hotel, January 19, 1979.

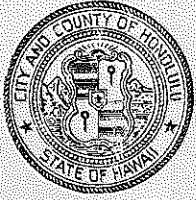
These conferences, intended to give to your membership the advantages of meeting and hearing outstanding leaders in your chosen vocational field, are unusual examples of student initiative, imagination, and hard work which bring credit to our University and our State.

I am grateful to all who have worked so hard to make them a success, and hope you will be able to continue such conferences each year to promote excellence in your field.

With warm personal regards, I remain,

Yours very truly,


George R. Ariyoshi



FRANK F. FASI
MAYOR

MAYOR'S MESSAGE

The University of Hawaii Accounting Club and Beta Alpha Psi are to be congratulated for their joint sponsorship of the conference, "Accounting: A Glimpse Into the Future II".

This second conference has been designed to give participants a well rounded overview of the challenges and opportunities that exist within the accounting field.

Much energy has been devoted to the success of this meeting with top professionals from the mainland coming to Honolulu to discuss the current developments in accounting.

On a personal note, the City is well aware of the interest and enthusiasm of the UH Accounting Club members, for they have been involved with the IRS Volunteer Income Tax Assistance program in our satellite city halls for the past few years. For this help, I am deeply grateful. I extend best wishes to conference participants and sponsors. I am confident the event will enlighten and motivate all of you.


FRANK F. FASI, Mayor
City and County of Honolulu



MR. WILLIAM R. GREGORY

Present: Vice Chairman, AICPA
Chairman of the Accounting & Review Services Committee, AICPA
Member of the National Review Board, AICPA
Managing Partner of Knight, Vale & Gregory

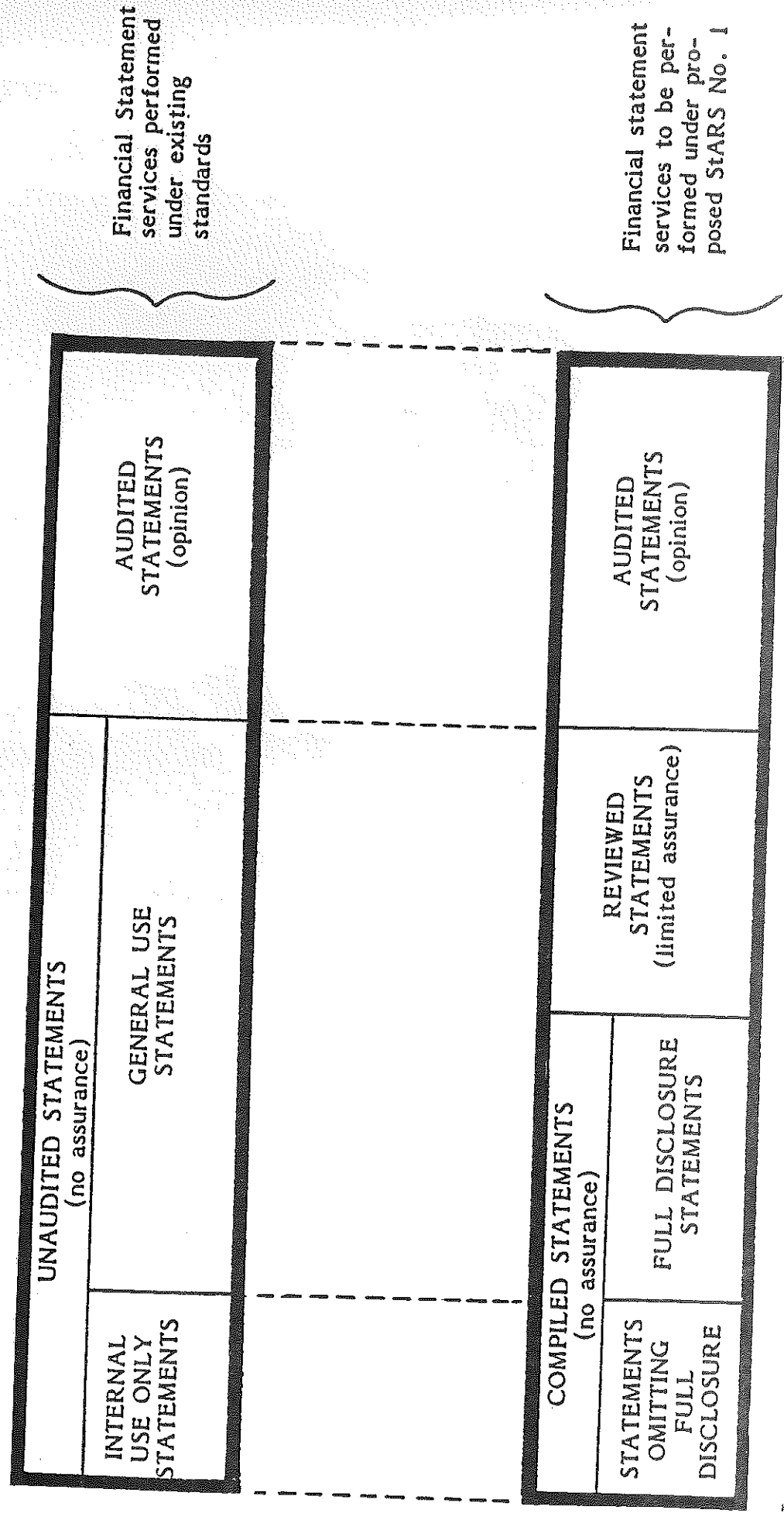
Past: Board of Directors, AICPA
Vice Chairman, National Review Board, AICPA
President of Washington Society of CPAs

Education: B.A. in Business Administration, University of Washington
M.B.A., University of Puget Sound
Member of Beta Alpha Psi and Beta Gamma Sigma

COMPARISON OF FINANCIAL STATEMENT SERVICES

For Non-Public Entities

Under Existing Standards and under Proposed Standards



COMPILATION AND REVIEW OF
FINANCIAL STATEMENTS

as presented by
MR. WILLIAM R. GREGORY

A new and fresh approach to a CPA's association with unaudited financial statements and the expression of limited assurance are the centerpieces of a new pronouncement being issued by the AICPA in January 1979.¹ The Compilation and Review of Financial Statements is the first Statement of the Accounting and Review Services Committee (ARSC) and will be known by the acronym SSARS I. The Statement is a significant step forward and a long awaited for clarification of the distinction between audited and unaudited financial statements.

The designation of ARSC as a senior technical committee status and SSARS I are two of the more substantive steps the AICPA has taken recently in addressing the problems of the smaller practitioner.

The preparation of unaudited financial statements is a major activity of a significant segment of the profession. Whether measured in fees generated or number of financial statements issued, the volume is enormous. Over 60% of the CPAs in public practice, approaching 50,000 CPAs, and 99% of the firms represented in the Institute are small practice units. In most small practice units, the preparation of unaudited financial statements is a major part of the practice.

Present Practice

Despite this fact, there has been very little authoritative professional literature dealing with the subject of unaudited financial statements. In the 500 pages of SAS 1, only four are devoted to unaudited financial statements. These four pages, Section 516, plus The Guide for Engagements of CPAs to Prepare Unaudited Financial Statements (The Guide), technically a staff guide without the authority of a SAS, are the basic guidance provided CPAs in the preparation of unaudited financial statements. There

¹SSARS I to be effective for periods ending on or after July 1, 1979.

are several reasons for this:

1. The body responsible for establishing auditing standards in the profession also had, until the appointment of the Accounting and Review Services Committee, the responsibility of providing guidance for unaudited financial statements. This body, the Auditing Standards Executive Committee (now the Auditing Standards Board), has been composed of members who are primarily audit oriented. Thus, AudSEC, by its very character, had little interest in developing guidance in the unaudited area.
2. Aside from the 1136 Tenant's case, which resulted in the AICPA staff guide in 1975, there have not been the unaudited engagement failures leading to the spectacular lawsuits experienced in the audit area. Such audit failures inevitably precipitated pressures for additional and beefed-up auditing standards. No such pressures developed for unaudited services.
3. The involvement of a CPA with unaudited financial statements has been considered by many in the profession to be a low and undesirable level of service relative to an audit. This attitude precluded the development of standards for the preparation of unaudited financial statements.

Not only has the guidance been minimal, but many practitioners have long had a concern about how to interpret and apply what guidance there was in Section 516 and The Guide. This concern was documented in a survey conducted by the AICPA committee on GAAP for Smaller and Closely Held Businesses. The survey revealed that practitioners believed:

1. Present reporting standards are not responsive to the needs of small businesses;
2. The disclaimer required by Section 516 did not address itself to the accounting services rendered and should be reconsidered; and
3. "Internal use only" statements should be abolished because they are routinely distributed to persons other than management.

This empirical data gave impetus to the appointment of a new committee to reexamine accounting literature dealing with unaudited financial statements. Originally created as a subcommittee of AudSEC, ARSC subsequently was granted senior technical status with the authority to establish

standards and procedures for accounting and review services a CPA may render in connection with financial statements of privately held entities.

Under present practice, CPAs issue two basic reports when associated with financial statements; i.e., an auditor's opinion or a disclaimer. Since SAP 38 was issued in 1967, the profession thus has been in the contradictory position of:

1. Stating clearly and correctly that the preparation of unaudited financial statements is an accounting service as distinguished from an auditing service, but
2. Illogically requiring, rather than proscribing, an auditor's report.

The inevitable result has been to lead the public to assume that financial statements having any association with a CPA have some connection with an audit. That is what, for all practical purposes, the courts held in the 1136 Tenant's case.

The attached schematic sets forth a comparison of financial statement services and an accountant's level of responsibility under existing and proposed standards. At the present time, the accountant either expresses an audit opinion or provides no assurance when associated with unaudited financial statements. Under proposed standards, a client would have the choice of compiled statements, with no assurance being expressed by the accountant; reviewed statements, with limited assurance being expressed by the accountant; or audited statements, in which an auditor's opinion is expressed.

Compilation

A Compilation is defined as presenting in the form of financial statements information that is the representation of management without undertaking to express any assurance on the statements. This would generally include all disclosures and footnotes. The key to a Compilation is that it is a service that does not have as its objective the expression by the accountant of any assurance on the financial statements. This does not mean that the CPA can accept financial data indiscriminately without having a professional responsibility for it. First, the general standards of the profession apply to a Compilation. The application of due

professional care is a fundamental responsibility of a CPA. Secondly, a Compilation requires that the CPA possess a level of knowledge of the accounting principles of the industry in which the entity operates that will enable him to compile the financial statements. He should also possess a general understanding of the nature of the entity's business transactions, the form of the accounting records, qualification of the accounting personnel, and the form and content of the financial statements. Basically, the CPA must have a reasonable, professional basis for accepting the data supplied by the client. This is not too different than the present quality control standards that apply to us all.

The accountant's report for a Compilation has been designed with the objective of stating what was done, what a Compilation is not, and the level of responsibility of the CPA; i.e., not undertaking to express any assurance.

COMPILATION REPORT

"The accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and changes in financial position for the year then ended have been compiled by me (us).

"A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them."

A Compilation will be permitted when a CPA is not independent providing he states in his Compilation report that he is not independent.

A Compilation has a definite role in the services a CPA performs for his clients. There are many situations in which the client or other user of the financial statements does not want or need a CPA's assurance on the financial statements and further, does not wish to pay for the extra cost of obtaining it. A Compilation will most often be used for interim financial statements but may be useful for annual financial statements.

Also, there are many situations involving interim financial statements in which the client and/or banker do not want the disclosures commonly contained in footnotes. In the banker's case, he may want only the "bare numbers" in order to keep his fingers on the company's pulse. These "bobtailed" type of statements thus serve a useful purpose. They provide

trend data, and when tied to the full-blown reviewed or audited financial statements, they provide a complete and continuing record of the company's activities. Therefore, SSARS I provides for the issuance of such a financial statement. It does require, however, a clear warning to any user in the accountant's report. In addition to the standard wording of the Compilation report previously quoted, the following paragraph is added:

"Management has elected to omit substantially all of the disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the company's financial position, results of operations, and changes in financial position. Accordingly, these financial statements are not designed for those who are not informed about such matters."

The last two sentences communicate to the reader the limited and special purpose of this type of financial statement and sound a clear warning to the reader that there could be important information missing.

Review

A Review is defined as performing inquiry and analytical procedures that provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles or, if applicable, with another comprehensive basis of accounting. The standards for the review of financial statements require the accountant to possess the level of knowledge of the accounting principles and practices of the industry in which the entity operates and to have an understanding of the entity's business that will provide him, through the performance of inquiry and analytical procedures, with a reasonable basis for expressing limited assurance.

The accountant's degree of understanding of the entity's business should be greater than that in a Compilation and should include a general understanding of the entity's organization, its operating characteristics, and the nature of its assets, liabilities, revenues and expenses. This would ordinarily involve a general knowledge of the entity's production, distribution, and compensation methods, types of products and services,

operating locations, and material transactions with related parties. An accountant's understanding of the entity's business is ordinarily obtained through experience with the entity or its industry and inquiry of personnel of the entity.

In addition, the accountant is expected to make inquiries of client personnel concerning the entity's accounting principles and practices, and the procedures for recording, classifying and summarizing transactions, and accumulating information for disclosure in the financial statements. Furthermore, analytical procedures should be performed to identify relationships and individual items that appear to be unusual. Inquiries are expected to be made of the actions of the stockholders or owners of the business; the financial statements should be read to consider whether they appear to be in conformity with GAAP; and inquiries should be made of persons who have a responsibility for financial and accounting matters.

Although the form and content of working papers are not prescribed for a Review, the Statement does require the accountant to prepare working papers that describe the matters covered in the accountant's inquiry and analytical procedures and any unusual matters of the accountant considered during the performance of the Review, including their disposition. An accountant may wish to obtain a representation letter from the owner and/or manager but is not required to do so.

The Review report describes the accounting service rendered, states that the information is the representation of management, compares a Review to an audit, disclaims an audit opinion but expresses limited assurance by stating that the accountant is not aware of any material modifications that should be made to the financial statements.

REVIEW REPORT

"I (we) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and changes in financial position for the year then ended, in accordance with standards established by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

"A review consists principally of inquiries of Company personnel and analytical procedures applied to financial data. It is substantially less in scope than an examination in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

"Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles."

In contrast to a Compilation, an accountant is precluded from issuing a Review report on financial statements of an entity as to which he is not independent. If the accountant is not independent, he may issue a Compilation report provided he complies with the Compilation standards.

Alternatives Now Available

A Review may well be considered to be an alternative to an audit. The deluge of SASs responding to the pressure of government and others to place greater and greater responsibilities upon the auditor has driven up the cost of auditing to the point that many companies are concluding that the cost of an audit exceeds the benefits. Therefore, an alternative to an audit was an economic inevitability. This is not to say that companies should indiscriminately replace an audit with a Review, but it does enable the client and his banker, for example, to make a judgment as to whether or not an audit is necessary or whether a Review will suffice. Most practitioners have situations in which a Review would be an appropriate service as compared to an audit and at the same time, lower the client's costs.

Thus, there are now choices that can be made by the client and/or his banker; the selection depending upon the need and uses of the financial statements and the level of responsibility and degree of assurance or nonassurance that is desired. It is no longer a black or white situation.

Thus, we will now have three basic services in connection with a CPA's association with financial statements: a Compilation, with or without disclosures, in which the CPA does not express any assurance; a Review in

which the CPA makes inquiries and performs analytical procedures to enable him to achieve and express limited assurance; and an audit in which the CPA performs an examination in accordance with GAAP to enable him to express an auditor's opinion. A clearer definition of accounting services leading to the preparation of financial statements, specific standards and procedures for each level of service, and accountant's reports descriptive of the service rendered are all significant improvements in the guidance provided the profession in the preparation of unaudited financial statements. The major breakthrough, however, is the ability of the CPA to express limited assurance when a Review has been performed. A Review will give the preparation of unaudited financial statements the stature and respectability that is warranted and long overdue.



MR. EDWIN M. LAMB

- Present: Chairman of the Professional Ethics Executive Committee, AICPA
Western Regional Director of Accounting and Auditing, Arthur
Young & Co.
Audit Partner, Western Regional Office, Arthur Young & Co.
- Past: Member of the Auditing Standards Executive Committee, AICPA
Chairman of the California State Society Committee on
Professional Ethics
President and Vice President of the California State Society,
Los Angeles Chapter
- Education: B.S. in Accounting, USC (Summa Cum Laude)
Master of Accounting, USC

THE IMPACT OF CURRENT EVENTS ON THE
FUTURE OF ACCOUNTING AND AUDITING

as presented by

MR. EDWIN M. LAMB

I am pleased to be in Honolulu today to present some comments on the impact of current events on the future of accounting and auditing. I will address by comments to the impact both upon the practicing CPA and management.

In recent years much attention has been paid to the accounting profession by Congress and various governmental agencies. The Watergate affair caused Congress to focus on political ethics. This in turn brought about an investigation of the ethics of American business. Several large business scandals, such as Equity Funding, Westgate, United Financial and Penn Central, were used by members of Congress to question the ethics of American business. These were followed by the general furor over so-called questionable payments by American companies to foreign government officials, commission agents and others to obtain business overseas. The business failures and the questionable payments issues were the subject of numerous Congressional investigations, highlighted particularly during the last campaign season. Out of these investigations came two questions. First, "How could managements' accounting systems cover up these types of activities?" and, second, "Where were the auditors?"

Congressional concern over the accounting profession was heightened a couple of years ago when the late Senator Lee Metcalf's committee commenced an all-out investigation of the accounting profession. After numerous hearings the Metcalf committee's staff issued a lengthy report which was highly critical of the profession. The report contained such allegations as auditors were, in fact, not independent and were guilty of poor quality work. Allegations such as these tended to discredit the report. The subcommittee continued its work and in November 1977 issued a much shorter committee report which was more tempered in its criticism but which did contain some 20 recommendations for the improvement of the profession. About the same time as Senator Metcalf's subcommittee was working, Congressman John Moss's committee was also investigating the profession, and Senator Proxmire was proposing legislation which has now become the Foreign Corrupt Practices Act of 1977. In addition, the Securities and Exchange Commission was making proposals for changes. More recently the Federal

Trade Commission commenced its investigation of our profession.

While all of these outside forces have caused the accounting profession to reexamine its internal and public posture, we must not lose sight of what the profession has been doing by itself to initiate improvements. Long before the commencement of governmental inquiries the American Institute of CPAs appointed a committee to reexamine the accounting standard-setting process. This resulted in the formation of the Financial Accounting Standards Board, which took the accounting standard-setting process out of the AICPA and placed it into an independent group, thus enhancing public confidence in the profession. On the auditing side the AICPA appointed the Commission on Auditor's Responsibilities, commonly known as the Cohen Commission. The Cohen Commission issued its first report in 1977 followed up by a final report in early 1978. As a result of all of these influences, both outside of the profession and within the profession, changes have been made, and will be made, which can have a profound effect on the future of accounting and auditing, both from the standpoint of the practicing public accountant and the management accountant.

I would like to comment today on what I perceive as the more significant areas of this impact on accounting and auditing. These are:

1. Professional regulation,
2. Professional business practices,
3. Responsibilities with respect to information other than annual financial statements,
4. Revisions in reports on financial statements and
5. The efforts of government to make the auditor a policeman.

Professional regulation

The accounting profession has long been self-regulatory. The AICPA and all of the state societies have maintained a Code of Professional Ethics under which members have been disciplined. However, there was no mechanism for the disciplining of entire firms. Recognizing the need to enhance public confidence in the profession's self-disciplinary process, in the Fall of 1977 the AICPA established a Division of CPA Firms. This Division is comprised of two sections, one whose members are firms which have SEC practice and the other having members not engaged in that type of practice. The requirements for membership in these two sections do not differ significantly and, therefore,

I will limit my comments to the SEC Practice Section.

To be a member of the SEC Practice Section a firm must abide by a number of conditions, which include;

1. Adherence to all quality control standards established by the AICPA;
2. Cause a firm to have a peer review of its practice once every three years, or more frequently if required by the Section;
3. Ensure that all professional personnel in the firm receive at least 40 hours of continuing professional education each year;
4. Periodically rotate partners in charge of SEC engagements; and
5. Ensure that a partner other than the one in charge of an SEC engagement perform a concurring review before audit reports are issued.

The Section is administered by an Executive Committee which is supported by a Peer Review Committee. In addition, all activities of the Section are subject to review by a Public Oversight Board, which is comprised of five distinguished members drawn from outside of the profession.

The requirements of membership are obviously designed to improve the quality of professional services. The failure of a firm to adhere to the membership requirements can bring about serious consequences. The Section's Executive Committee is empowered to impose sanctions on member firms. These sanctions include:

- Requiring a firm to take corrective action, including appropriate action with respect to individual persons within the firm;
- Requiring additional continuing education;
- Requiring accelerated or more frequent peer reviews of the firm's professional practice;
- Reprimands;
- Monetary fines;
- Suspension of a firm from membership in the Section; and
- Finally, expulsion of a firm from membership.

Thus, unless a firm receives a "good housekeeping seal of approval" from its peer reviewers, the result can either be costly or more disastrous. At the extreme, if a firm is suspended from membership or expelled from the Section, it

will be forced to give up its SEC clients.

Two of the requirements of membership deserve a little more comment. First, let us take a look at what a peer review is all about. A peer review of a firm's professional practice can be conducted by a committee appointed by the Section or by another CPA firm. The reviewers evaluate the firm's quality control system for compliance with the standards promulgated by the AICPA. They then proceed to test the evaluation by reviewing a sampling of working papers and other documentation relating to specific engagements. If the peer review is conducted by another public accounting firm, its work is monitored by a quality control panel comprised of individuals selected from other firms. These panel members test the work of the peer reviewers and must be satisfied with the conclusions reached. At the conclusion of the review both the reviewing firm and the panel issue a short-form report which either concurs or does not concur that the firm's quality control system is in compliance with professional standards. In addition, a longer report is issued when the reviewers have recommendations for improvement.

On top of this peer review process is the Public Oversight Board. Members of that Board have access to the findings of the peer reviewers and they must be satisfied with the findings. In cases where sanctions are imposed the Public Oversight Board will review the sanctions to determine whether they are sufficient. In addition, the Securities and Exchange Commission has indicated it will utilize the Public Oversight Board to satisfy itself that the profession is adequately regulating itself.

Another membership requirement is that of constant continuing professional education. All firms who are members of the SEC Practice Section must ensure that all professional employees, which include both CPAs and non-CPAs, must receive at least 40 hours of qualified education a year. This generally means that every person involved in the quality control process is subject to this requirement. Although many states currently have continuing professional education laws and many firms have policies requiring such education, the AICPA's membership requirement may cause some firms to require education for personnel not previously receiving it. For example, persons responsible for assigning staff to engagements and bookkeepers performing accounting services for clients would appear to be subject to this requirement. Firms will have to reexamine their structure to determine who are professional employees and who are not. In my opinion, all personnel in a firm, except clerical staff, are

professional employees. To meet this membership requirement some firms will be incurring additional cost.

The establishment of the Division of Firms, which provides self-regulation of accounting firms, does not, of course, mean that the profession no longer has a Code of Ethics which is used for disciplining individuals as opposed to firms. Quite to the contrary, the AICPA's Professional Ethics Executive Committee has been very active in tightening up ethical standards, especially in the area of independence. Several pronouncements are currently in process, including rules for determining independence in cases where CPAs have investments in nonclient joint ventures and in limited partnerships. The AICPA is expanding its ethics enforcement activity by developing a program to actively seek out auditors' reports for review to determine their compliance with the technical standards of the profession, that is, adherence to generally accepted accounting principles and generally accepted auditing standards.

In the area of independence members of Congress have questioned whether CPAs are, in fact, independent when their firms render management advisory services to their audit clients. At the initiative of the AICPA this entire area is currently under study by the Public Oversight Board, which is expected to make a recommendation in the near future. Changes in this area will impact both the large and the smaller public accounting firms. For example, if the Public Oversight Board decides that certain types of management services should not be rendered to audit clients, even the smaller firms will be affected because a good portion of their practice consists of advising management.

These are the attempts by the profession to regulate itself. Some members of Congress, however, are not satisfied. For example, Congressman Moss last year introduced a bill which would require the establishment of a public organization subject to SEC oversight to regulate the profession in a manner similar to the way in which stock brokerage firms are presently regulated. This bill did not pass.

The SEC has acknowledged that it has a responsibility to oversee the profession and has committed to Congress to review the profession's efforts and to report each year to Congress. In its June 1978 report the SEC concluded that the profession was making sufficient progress in self-regulation to merit giving the profession continued opportunity to pursue its efforts. Therefore, the Commission did not recommend legislation. The Commission observed that the peer review program is the heart of the self-regulatory process and that the

profession must commit itself to make this process work. The Commission's oversight [of the profession] is continuing and another report is due to Congress in June of this year.

Professional business practices

Although there has been a tightening of ethical standards and enforcement procedures in the areas of independence and technical standards, there has been a relaxation in the ethics rules governing advertising and solicitation. Virtually all of the rules which the profession previously had prohibiting advertising and solicitation have now been withdrawn because of various Supreme Court decisions involving other professions which had similar rules. Basically, the new rules with respect to advertising and solicitation appearing in the Code of Professional Ethics merely prohibit false and misleading acts.

It is difficult to predict the effect of the relaxation of the rules on advertising and solicitation on the profession at this time. While there has been some scattered advertising which openly solicits clients, the indications are that it is not very productive. Only two of the large national firms have engaged in advertising, but both have been directed toward public service rather than selling particular areas of expertise.

With respect to the direct solicitation of clients of other CPAs, however, there has been some more activity. Recently there have been a number of instances where one CPA firm has directly solicited the business of other CPA firms. There also has been some indirect solicitation. For example, one firm publicly offered to assist its clients in improving systems of internal control, promising a 10 percent reduction in audit fees over a three-year period. Fortunately for the profession, solicitation has not become widespread, but if it does it will lead to competitive bidding at low rates which could well have an effect on the quality of work performed. In this respect this government-imposed relaxation in our Code of Ethics can conceivably run counter to the proposals I have previously mentioned for the maintenance of high standards of quality work.

Reporting on information other than annual financial statements

Corporate managements and the accounting profession have long reacted to the informational needs of investors, creditors, securities analysts and government agencies by reporting more and more financial information. This includes quarterly financial statements, forecasted information, current value financial

statements and other information on the effects of inflation.

Much of this information is known as "soft information" and with its publication has come the desire on the part of many that auditors should be involved.

Quarterly financial information has been around for quite some time, but it was only in the last few years that auditors have become associated with this type of unaudited information. Statements on Auditing Standards Nos. 10 and 13, issued in December 1975 and in May 1976 in response to requests that auditors involve themselves with this type of unaudited information, set forth suggested procedures for auditor review of the information and established standards for the auditor's report thereon. The review procedures generally consist of inquiry and analytical review, but they are open-ended, permitting the auditor to extend his procedures if his review raises questions about the information. The reporting standards, with one exception, require the auditor to disclaim an opinion on the information. The one exception, that of reports submitted to the SEC accompanying Form 10-Q financial statements, permits the auditor to give assurance that nothing came to his attention that would require adjustment of the financial statements.

The American Institute's Accounting and Review Services Committee has, however, issued a Statement which would permit accountants to express assurance on unaudited financial statements based upon review procedures which are even less than those contained in SAS 10. This was described by Mr. Gregory earlier today. The issuance of the Statement of Standards for Accounting and Review Services has created an inconsistency in professional literature and, therefore, the Auditing Standards Board (formerly the Auditing Standards Executive Committee) is in process of issuing an SAS revising SASs 10 and 13.

The new SAS, which is scheduled for exposure next month, will provide that when an auditor performs a review of quarterly financial information applying the presently contained in SAS 10, he may provide assurance using the following language:

Based upon our interim review we are not aware of any material modifications that should be made to the accompanying financial statements.

Thus, with the issuance of the Statement on Standards for Accounting and Review Services and the proposed Statement on Auditing Standards, accountants will be

taking more responsibility on themselves for unaudited information.

There are other areas in which there are pressures on the profession to take more responsibility for soft information. For some time there have been proposals that companies should provide forecasts of operations for the information of potential investors and others. Several proposals have come from the SEC. A current proposal from the Commission provides that companies may present such information at their option, but if they do so they must continue. Naturally, auditors will be expected to say something about that information. The Auditing Standards Board is currently in process of developing as SAS setting forth standards for the review of forecasted information and accountants' reports thereon. The standards for review which are being considered are similar to present generally accepted auditing standards, adapted, of course, to fit the forecasting situation. For example, the standard of independence would remain. The accountant's report presently contemplated would state that he has examined the forecast in accordance with the standards established by the AICPA and that, in his opinion, the forecast was prepared in accordance with procedures recommended by the AICPA and that the assumptions used are reasonable.

With the continuing inflation, pressures have been brought on management to supply current-value and other price-level information. The SEC already has a requirement that certain companies must report replacement cost data. Auditors are already involved with replacement cost data and it may well be expected that inflation information will become more and more prevalent in financial statements with consequent auditor involvement.

Another area of interest to investors and others is that of internal controls which management has established in its accounting system. The Cohen Commission recommended that managements report to the public on the sufficiency of their internal accounting control systems and that auditors should attest to management's representations. The AICPA appointed a special committee to study standards for internal accounting controls and that committee recently issued an exposure draft of its report. It is anticipated a final report will be forthcoming in the middle of this year. After such standards have been recommended the next obvious step again is for auditor involvement in reporting on the condition of their clients' internal accounting control systems. Obviously, with such public reporting on internal controls the managements of many companies will have to take positive action to improve their systems because if they do not, they will be faced with unfavorable reports. Needless

to say the SEC is most interested in this area and is one of the driving forces encouraging such public reporting.

A related subject involves the Foreign Corrupt Practices Act, which is the topic of Mr. Johnson's speech today. Without encroaching on Mr. Johnson's speech, suffice it to say that this Act requires companies which are subject to the SEC to maintain sufficient systems of internal accounting control, regardless of whether the companies are engaged in foreign activities or not. Failure to comply with provisions of the Act subjects managements to penalties. It can well be expected that managements, audit committees and boards of directors will want assurance from their auditors that the companies' systems are in compliance with the Act. In fact, our firm has already received some requests to render such reports.

New forms of reports on financial statements

Aside from the impact on auditors and managements of the growing need for soft information and information on internal controls, some major changes are in process with respect to the annual report. The Cohen Commission recommended that management should report on its own financial statements and that auditors should report separately in an expanded format.

In response to the Cohen Commission report the AICPA appointed a special committee to consider management's own reports on its financial statements. That committee recently issued a report of its tentative conclusions and recommendations. Generally, it recommends that management should report on its financial statements informing users of management's responsibility for those statements. The committee recommends such a report would include:

- Management's representation as to its responsibility for the financial statements,
- Management's assurances that the objectives of internal controls are met,
- A description of the composition and duties of the company's audit committee,
- A description of the role of the independent auditor and
- Any other matters which management considers appropriate to comment upon.

It can be expected that the trend will be in this direction. In fact, a number of large companies last year provided reports by management on the financial statements in the annual report to stockholders.

Also arising from the Cohen Commission report, the AICPA's Auditing Standards Board has been considering changes to the standard form of the auditor's report. The purpose of changing the report is to expand the information provided to readers as to the nature of the auditor's examination and the extent of his responsibilities. The Board is currently considering a report, which reads as follows:

The accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings and changes in financial position for the year then ended are management's representations. The recognized basis for those statements is generally accepted accounting principles. Those principles consist of conventions, rules and procedures, developed by authoritative bodies and through custom and common usage, that provide a framework for financial presentations. The selection and application of generally accepted accounting principles appropriate in the circumstances requires judgments by management. Judgments and estimates by management are also required in determining certain amounts and disclosures and in reflecting within reasonable limits the substance of underlying transactions and events.

We have audited the financial statements in accordance with standards established by the American Institute of Certified Public Accountants. The application of those standards requires the use of judgment by the auditor in designing and performing selective tests of accounting records and in obtaining persuasive [sufficient competent] evidential matter [corroborating information] sufficient to provide a reasonable basis for the expression of an opinion on the financial statements taken as a whole. Decisions as to the nature, timing and extent of procedures used depend in part on the degree to which the auditor relies on internal accounting controls. An audit provides the auditor with reasonable, but not absolute, assurance that the financial statements taken as a whole are not materially misstated as a result of errors or irregularities.

In our opinion, the financial statements referred to above present the financial position of XYZ Company as of December 31, 19XX, and the results of its operations and the changes in its financial position for the year then ended in conformity with generally accepted accounting principles.

No doubt the Board will expand the language which I just quoted to include the auditor's opinion on management's representations as to the company's internal control system.

The auditor as a policeman

There is another series of pressures on the accounting profession and management coming primarily from the SEC. In essence this series of pressures can be characterized as a desire on the part of government for the auditor to act as a policeman and for management to improve its ethics.

As a result of the furor over foreign questionable payments, most companies have adopted corporate policy statements governing ethical behavior. The SEC has made a proposal that audit committees be required for all publicly-held companies. The SEC has also recently required, through the issuance of Accounting Series Release No. 250, the disclosure by management of information relating to its relationships with independent auditors. These include descriptions of services rendered by auditors other than those involved in the examination of financial statements and whether or not the auditor's services were approved by the audit committee or board of directors. Further, management is to disclose whether the board of directors gave due consideration to the possibility that nonaudit services rendered may impair the auditor's independence. These requirements came into effect late last year.

In more recent series of proposals the SEC has amended the proxy rules to require a series of disclosures by management in an attempt to improve what the SEC calls "corporate governance." These disclosures are extensive and include such matters as relationships between directors or potential directors with the company, information about any audit, nominating or compensation committees and a description of any director's disagreement with management over operations. These requirements came into effect this week. Down the road it may be expected that auditors will be required to provide some assurance as to the correctness of some or all of these various types of management representations.

In the early history of the development of what is now known as the Foreign Corrupt Practices Act, the SEC made a proposal that the legislation contain a provision making it a crime for any person to lie to an accountant or auditor associated with financial statements. Many difficulties were perceived with this proposal. For example, it is common practice for an auditor to obtain confirmation from a company's customer as to the accuracy of an account receivable from that customer. It is also common practice to obtain confirmations from

banks as to bank balances. Under the proposed legislation people signing and returning confirmations could well refuse to do so because a mistake on their part could be conceived as lying to an auditor. Further, all audits involve conferences with management and other client employees. It was perceived that people would be reluctant to talk to an auditor in some situations without having legal counsel present. Obviously, problems such as these would only serve to delay audits and make them more expensive. Therefore, the anti-lying proposal was not adopted. Had it been adopted the natural consequence would have been to require the auditor to report any known lying to him to some government agency. Unfortunately, this defeated proposal is now being revived.

Another topic involves the auditor's responsibility for "whistle blowing." The question is, "How much responsibility does the auditor have to inform the public and the government of errors and irregularities and other matters which come to attention?" At the present time the auditor reports in accordance with a well-defined set of standards. He is not required to tell the public about every error or irregularity he may find. He is only concerned with those matters which are material to the financial statements, and if corrections are made by management, in most instances there will be no effect on the auditor's report. There are those, however, who persist in attempting to expand the auditor's whistle-blowing responsibilities and they may well have some success.

Summary

These, ladies and gentlemen, are some of the more significant things which we can foresee in the future of accounting and auditing. They involve both independent auditors and management. They represent a challenge to all of us, whether we are the newest accounting student or a top executive in the profession or in management.



MR. KENNETH P. JOHNSON

- Present: Vice Chairman, Technical Counsel of Coopers & Lybrand
Member of the Committee on Accounting and Auditing,
Coopers & Lybrand, International
Chairman of the Committee on Corporate Conduct, AICPA
Member of Financial Accounting Standards Board's task forces
Co-author of the Ninth Edition of Montgomery's Auditing
- Past: Chairman of the Auditing Standards Executive Committee, AICPA
Chairman of the Cost Accounting Standards Board
subcommittee, AICPA

THE FOREIGN CORRUPT PRACTICES ACT:
THE INCREASING ROLE OF THE INTERNAL AUDITOR

as presented by

MR. KENNETH P. JOHNSON

I am going to talk about the Foreign Corrupt Practices Act [FCPA] and then I'm going to try and relate that to some of the changes that are happening in the accounting profession. My emphasis is going to be on the role of the internal auditor, because one of the consequential results of the FCPA, in my opinion, will be to raise the role of the internal auditor in America's corporate structure and I think this has some implications for the accounting profession. I think it has some implications for corporate governance, I think it has some implications for those who regulate the accounting profession that, of course, is the SEC, and, finally, I think it has important implications for the internal auditors themselves because, unless they are prepared to step forward and accept the new responsibilities, will miss what I think will be an excellent opportunity.

The interesting thing about the Act is that it requires, for the first time, registrants to maintain a certain level of internal accounting control, and you know that internal accounting control is one of life's great mysteries. In this area, which, frankly, is not much understood at the present time, we now have specific requirements that will need to be applied and there are a lot of lawyers who are willing to help us with this definitional problem and there are a lot of enforcers down in the SEC who are very anxious to use this law to broaden their own outreach into American corporations. There have already been four cases, significant cases, where the SEC has used the FCPA as part of injunctive proceedings against corporations. The first one was in March 1978, barely four months from the date the Act was passed.

The interesting thing about the law is that there is not now a good understanding of what constitutes adequate internal accounting control, and while we professional writers on accounting subjects like to stick in ideas like the cost should not exceed the benefit, the practical fact is that there is no mechanism available today to measure the benefit of good internal accounting control. It just doesn't exist. And it means that the application of the concept has to be done subjectively and in the absence of measurement

devices that allow the auditor, or, particularly the manager of the enterprise, to assess the benefit of control. We are going to have to use rules of thumb. This means that there is a good deal of developmental work that must go on in the immediate future, and it is going to impact on all of us, but especially the corporations. The SEC will be publishing for exposure a new requirement that will require American corporations for 1979 to report the degree to which their own internal accounting controls meet the requirements in the Act, specifically, what the corporation has done to reach that opinion, and finally the corporation is going to have to disclose any significant weaknesses in control that have not been corrected. The outside auditor is not immune because the AICPA has committed to deliver to the SEC by June 1979 rules that will allow the external auditor to report on his clients' internal accounting controls. The view right now among the staff of the SEC is that the auditor will have to give his opinion on the clients' three responses about the Act. It means that in early 1980 we are going to be facing the reporting requirement. The key in the Act is the notion of "reasonable assurance." At this point terms need to be defined. The interesting thing is that the concept of reasonable assurance means some rate of error will be tolerated by the system. It will fall to management to be able to demonstrate precisely how they went about tailoring their own internal accounting controls to meet the needs of the Act, and that demonstration will be their documentation of the good faith and care that they have applied to this phase of the management system. It means corporations will need a specific program for 1979. There will be things for them to do and we have something called an action program that includes a number of steps that can be applied right now.

The external auditors, being mindful of these developments, have been very careful. In C&L we tried to make sure that our comment letters on weaknesses in internal accounting control were delivered in 1978, because the SEC's new reporting requirement will cover the whole year of 1979 and we did not want a good letter delivered at the wrong time of the year to cause embarrassment to the client or to their audit committee by pointing out many things the auditor thinks in their system needs to be changed. It is not too late for companies to consider the type of plan they want to carry out in 1979 to be able to meet this prospective new requirement. I have not read the SEC release.

I did a test, in 1978, on 1977 annual reports to see how many large companies managements were already giving their views about internal accounting

controls. From my test I picked the 33 blue ribbon companies that are represented on the Financial Executive Institute Committee on Corporate reporting. Of those 33 companies, more than 20% of them in their 1977 annual report made some sort of representation about their internal accounting controls. The terminology was interesting, it was varied. The tone of the description varied from company to company. Some of the reports were signed by different corporate officers, some were not signed. The essential thing is that these large companies, who are pace setters, and among them ATT, GM, GE, when they began to publish management reports about internal accounting controls in their annual reports you could see the trend being set. The FEI, in 1978, put out two papers encouraging their members to encourage management of the companies where they work, because the FEI cannot set standards it can only encourage people in industry, to include in their 1978 annual reports comments about their internal accounting controls. Judging from the inquiries I have had, from C&L clients, my guess is that about 25% of the annual reports for 1978 will have some discussion of management's responsibility for both the financial statements and for internal accounting controls. Some of them, only a couple, will also have discussion about the roles of the audit committee and some will include in their annual report not only a discussion by management of their responsibility for the financial statements, and not only a report by the independent CPA, but a report issued by the corporation's own audit committee. So you can see the trend here is toward more disclosure, the trend here toward management's articulating the role that they play in corporate governance. We can begin to see the clear emergence of a new vehicle, the audit committee, which is going to play an increasing role in financial accounting, auditing, and reporting as time goes by. Now everyone knows that audit committees have been around since the McKesson-Robbins days. When the SEC looked into that matter which in the early 1930's one of their recommendations was that McKesson-Robbins have a committee of outside directors to look after certain nuances in financial reporting. That was the first American experience with an audit committee. They didn't have the right name, but essentially they had most of the concepts right. The AICPA jumped on the bandwagon in 1968 encouraging the use of audit committees. The SEC recently has been on the bandwagon - they have been suggesting a number of things, They encouraged the AICPA to put how a requirement saying that unless a corporation had an audit committee that a CPA couldn't be independent of the enterprise.

Fortunately, the AICPA didn't agree with the SEC's conclusion and we declined the opportunity to force audit committees on American corporations. Not to worry, because when we failed to accept it, we have another group in Washington, the Metzenbaum subcommittee has drafted legislation, not yet introduced, which proposes to mandate certain things about corporate governance. One of the things it is going to mandate, if legislation is introduced, is that corporations have an audit committee. They are going to set down uniform duties that they think the audit committee may be called upon to exercise. Bear in mind that the Metzenbaum bill has not been introduced; bear in mind, as well, that if you have read anything about it in the papers, that the American business community in this case is united against this type of legislative intervention in the system of corporate governance. American enterprise is suggesting discreetly to Senator Metzenbaum that he should abandon this exercise and spend time on other issues. Unfortunately, American industry may not be persuasive. I don't think the bill will be passed in this session of Congress. I don't even think that the bill has in it enough of the concepts that are important about American corporate governance to be qualified as a "good bill." I say that because, at the present time, one of the serious concerns is the liability that an outside director takes on when he agrees not only to be a director but to serve on the corporate audit committee. The interesting phenomena, and accountants find this fascinating, is that lawyers will agree that having an audit committee raises the liability of audit committee members and it does not reduce any of the other liabilities of the other members of the board of directors. Of course, as accountants who are used to the rule about whole not exceeding the sum of the parts, we find that difficult to deal with. But the key issue is that, with the growing liability, the emerging audit committee is going to turn somewhere inside the corporation for help. Already I have had two clear indications of one route that they may take. We at C&L, have been asked in two instances by companies that are not otherwise our audit clients to give specialized advice on internal accounting controls because the board of directors have decided that if they get this advice from their own auditors it somehow impairs the auditor's independence. A far more likely place for the audit committee to turn for help is the internal auditors. Now we have some interesting precedents. Back in the middle 60's a very eminent jurist, Arthur Goldberg, was elected to the board of directors of TWA. You remember that Justice Goldberg had been Secretary of Labor, had been given a position on the Supreme

Court of the United States and, at the request of President Johnson, he stepped aside to take a role in the administration. With this background, he went on the TWA board. You will remember that he resigned from the TWA board. He resigned because he felt that as an outside director of the corporation, he needed a separate staff of advisers to help him research the responsibilities that were borne then in the middle 60's by outside directors. TWA, the management and the other board members, when presented with Goldberg's plea for assistance, felt that was the wrong way to go. Goldberg resigned, but the issue was not forgotten, because in that issue we have the fundamental conflict between the obligations of management and the obligations of the overseers. While we can debate whether the overseer has the right to duplicate disciplinary procedures that should be exercised by management, we could all agree that overlapping points of authority are costly and these controls, must be cost-justified -- that is the benefit must exceed the cost. But we have to recognize as well that the outside directors who sit on the audit committee have limited insight into the corporate reporting. They have limited insight into the basic workings of the information getting and processing system that we call the accounting system, and they have limited time to explore the nuances of management control that affect that system that we auditors call internal accounting control.

We have got to give them a device. The device is called the internal auditor. I personally had experiences with audit committees of large corporations who use internal auditors on a monthly basis. There are a whole series of projects that are laid out for the internal auditors to execute. This doesn't mean that the internal auditors report to the audit committee, because administratively they do not, but it does mean that the internal auditor turns out to be the eyes and ears of the audit committee and, under the right sort of control, it is a pretty effective way to allow the discharge of the audit committee and the roles that are being thrust upon them.

I have given you two views. One view is that we will be required, under the FCPA, management, to give some sort of view about the degree that internal accounting controls meet the statutory requirements, and I say the best one to do that is the internal auditor. Then coming over the hill, is a new means of corporate governance, the audit committee. As the duties of the audit committee become more widely accepted, the audit committee is going to reach into the enterprise for help and they are probably going to settle on the internal

auditor. Corporate management is not immune from these pressures either. Remember that management has the responsibility for deciding which risks the enterprise can accept. If you think about it, management has to identify risks, classify the risks, decide which risks the enterprise will accept and which risks must be avoided, and on that basis, make a decision. They must decide whether to go into a new project on that basis. They decide whether to put up a new plant on that basis. They decide whether to produce a new product on that basis, and I submit that they decide what sort of control they need in their enterprise on that basis. When we specify controls we find out that internal accounting control is just one element of the control system that affects management on a day-to-day basis.

You can say what's new? You can read in Standard on Auditing Statements 1 where the auditor says that internal accounting control is management's responsibility. Or you can read in the annual reports where managements themselves accept the responsibilities for internal accounting controls. I will tell you that the only new thing is being able to put internal accounting control into the context of any other management system and, of course, that can't be done. We talked a little about the fact that managements in 1979 are going to have to report, probably to the SEC, about their internal accounting controls. We have to think now about what a corporation's management would put inside the entity so that they can get the right type of satisfaction to write their name on the bottom of that report. Where will they turn? They will turn to the audit function and, specifically, to the internal auditors. We have been doing a series of experiments in large public companies, our clients in the U.S., and we have been working with a number of internal audit departments to put some specific steps into the program. We experimented with them to get the right sort of interaction between the internal auditors, who are now the eyes and ears of management as well as the eyes and ears of the audit committee, and we have tried to develop their role so that they can go and look at internal accounting controls, make an assessment with the right degree of objectivity, and leave their suggestions behind for management to implement in the improvement of the day-to-day controls. Those experiments are working very well.

Recently, I went before the audit committee of a large company in the midwest U.S. -- I was a little bit happy about my role as an observer, because after the first discussion about the FCPA, the audit committee chairman turned

to the corporate controller and asked, "what is our corporate strategy for acceptable risks in the accounting records? What degree of error are we going to accept?" The controller was a little stunned. He couldn't quickly think of an answer, and, frankly, I couldn't either. Because in the control system there were no measurements. We just hadn't looked at it as a kind of business strategy. And to show you that the chairman of the audit committee was totally even-handed, he next turned to the audit partner and he said, "Suppose I told you that I am willing to tolerate errors up to \$500,000. Then suppose I said how much more would your audit cost if I said make that number \$250,000?" My partner was a little embarrassed, because in thinking about the audit strategy, what size error would be acceptable. You begin to get some new implication of the concept of materiality, and when you think of the payoff by the audit effort and possibility of minimizing an accounting error, you begin to see some new possibilities for increasing the effectiveness of the audit function. That has two parts in it, internal plus the external auditor. That meeting was the genesis of a series of corporate experiment where we are really trying to make the measurements. We are trying to develop corporate strategies. We are trying to articulate the notion of reasonable assurance in a practical way with day-to-day operations and I am talking in a way managers of corporate entities can understand. The interesting thing is it isn't so hard.

Probably even more interesting is the idea that the people that we are working with when we begin to talk about the ideas pick it up very quickly. It is not a new notion to a manager, it is what he does. We have developed for example, in the Sun Company, some local internal accounting control committees. When the audit function, which includes both internal and external auditors, identifies something that is a potential weakness in the system of internal accounting control, that weakness is turned over to the management committee. On the management committee we have an accountant from the controller's department, an internal auditor who represents the headquarters activity, the local plant manager and in some cases, we have a member of the corporate legal staff. We find that the committees are able to identify the types of control very easily and what we find is that, without a great deal of fuss, they can deal with them in a practical sort of way. We are documenting those committee members as part of the results of those experiments and ultimately to become part of Sun Company's documentation of the questionnaire that they are putting

into analyzing their internal accounting control systems. The point is that management needs the internal auditor in this role. The internal auditor is being tested and, generally speaking, he is performing in an outstanding way. We still have some more to go in our experiment. For example, we are trying now to decide and we are thinking about the SEC requirement -- who in the company is going to sign the letter about the appropriateness of the internal accounting controls. We are drafting some reports that would be issued by the internal audit function that will wind up being delivered to the board of directors and to management of the enterprise. It is interesting that our preliminary view from one of the experimenting companies is that the audit committee wants the certificate about internal accounting controls executed by internal auditors. Something that delegates with it some relief to the audit committee from their responsibility. I'm not sure that is the case. I was sort of pleased when I heard about it because I thought that the particular decision represented the recognition by the audit committee of the importance of the role of the internal auditor to that enterprise. But, even in that case, I don't think the internal audit function has gone far enough. Part of the training we are doing is expanding the scope of the internal audit function and adding to it certain operational characteristics. C&L uses an internal control questionnaire. Among the questions that are in it are questions that relate not to internal accounting controls, but rather to the operating controls that have financial implications. We have gone beyond that by suggesting that the internal audit function should go fully operational. We are going to have two groups. One basically financially oriented--they will make what we call financial audits dealing with the operational controls that have financial implications such as purchasing control. We are going to have another group of operational auditors that deal in areas, such as OSHA, with matters like limits of insurability, efficiency of materials handling and, experimentally, those three groups will go forward to develop the operational aspects of internal audit functions. We are also going to do some additional auditing of program results. It won't be enough in this exercise to restrict the auditing to financial results, but we really will try to assess, with the right sort of skills, program results of that the enterprise is engaged with.

Where does this put us? I am mildly upbeat about the role of the internal auditor. I see some interesting premises that impact on the work our Firm is doing as well. For example, one of the developments of our experiment that has

caught on with almost everybody is something we call the user common file. Let me describe that. Under the C&L system, we auditors make a description of the existing internal accounting controls of the enterprise. The auditor analyzes those controls on an annual basis and he makes these judgments about his audit program on the basis of his assessments of those controls. He uses the technical advice of a questionnaire to help him get uniformity in his approach. The thing that is wrong about that is that all of this documentation, until a few years ago, stayed in the auditor's work papers. So when the internal auditors went to the enterprise, even if they were auditing the same location, they had to start anew, and if the companies have systems departments or management departments interested in accounting systems, they had to prepare their own documentation anew. We had a very simple idea. The simple idea is that this documentation, which is prepared, incidentally, by company personnel, stays under a control at each appropriate accounting location. When you go to a particular operation there will be a user common file and in the file will be some flowchart notations of the accounting system in that operation. There will also be some questionnaires that assess the importance of the controls, and also in the file will be the C&L Internal Control Reference Manual which serves as a guide to give uniformity to the interpretation of these subjective areas. It will be under a control, that is, those people who are authorized to get into it are limited to three different roles. - external auditors, internal auditors and managements systems people. Local employees have the responsibility to keep the file up to date. Incidentally, what we find is that responsibility if it is properly executed it is often the only recording of many day-to-day changes that are made in the accounting system as new transactions develop or as conditions change in the enterprise. The obvious advantage you can see. When external auditors arrive, we get into the file, we use it for our purposes, we write a report on anything we find is improper in that file or things that are being questioned, and we put the file back. When the internal auditors get in, they do the same thing, and you can see the obvious cost savings that are apparent here. We certainly make the audit function more effective by freeing up time from essentially an analytical, sort of clerical operation. We still have to test it, but at least we don't have to document it, freeing up that time to go into other activities it can result in significant savings. It also reduces the time of the internal auditors' examination. Again, when he gets in he uses the files, he tests it,

he makes a report of anything he feels has been improperly documented in the file, and then he puts it back. And, of course, not having to make his own analysis anew, plus having the reference manual as a common base, has raised the effectiveness of that particular operation very significantly. The result is that they have time to get out into other areas, like operational areas, that, under the other approach, may not have been totally available. You've got to remember that the audit function is a control. It's just like every other control -- that is the benefits should exceed the cost. When we can reduce the cost of the internal audit function we're making a concrete saving for the entity.

To make the job even better, we've got to look at the organization of the internal auditors themselves. The Institute of Internal Auditors is already underway with this program. They have standards out for how to judge the effectiveness of an internal audit department. I think they are pretty good standards for a start. We've got some work to do in this area as well. One is that an internal audit function, to be effective, has to have the right degree of objectivity, it has to have the right sort of stature in the corporate enterprise. There are two companies, Unilever is one, and Phillips is another, based in the U.K. and Holland. Both of them have finely developed internal audit functions. In the case of Phillips, the chief internal auditor sits on the supervisory board of directors. Those two internal audit departments are deemed by their managers as being essentially the same thing as an independent accounting firm that happens to only have one client. They say they are totally independent from the management enterprise. Some of us wonder if an employee ever has the right degree of objectivity to be "totally independent." If anybody can do it, those folks can. The reason that they can, especially in the Phillips case, is that the Phillips internal audit department has caused trouble for management many, many times over the past 20 years, but in every case the long-run interest of the entity has been preserved or aided as a result of the internal audit activity. So, at least in that company, the top supervisory board management are convinced that an objective hard hitting internal audit department is a benefit. Not every audit department is going to achieve that goal.

I know some in the U.S. that are tough as iron. When the internal auditor walks in and local management says to "do this", or "get out", I'm taking an inventory." The Internal Auditors say "I take my orders from headquarters."

They do a good job. Obviously not everyone is going to achieve this level. The thing that tends to help them get the right type of corporate stature is the effectiveness and efficiency of the internal audit operation. If you do a good job, management tends to welcome this as something that really does produce a benefit. One of the things that we at C&L are working on is a way to make more effective use of internal auditors in our ordinary examinations of financial records of clients. We have a program underway. We have trained internal auditors of about 170 of our clients in the concept of the FCPA. We have some courses going on right now in an effort to get a better understanding about controls and about the proper placement of the internal auditor communicated. We don't know the answers, but we have some ideas. People inside the corporations are beginning to see benefits flow from an expansion of the internal audit activities, and this in the long run will tend to buttress the place of the internal auditor in every position. What we are focusing on is the management of the internal audit activity. How does one manage and internal audit activity? What are the proper criteria for selection of candidates for the internal audit staff? How do you effectuate the trade-off that occurs with the internal audit staff being used as a training ground for candidates may be 5-6 years from the point when they enter the corporation. They spend 3-4 years on the internal audit staff and then move off to other training opportunities. They turn out to be pretty good people with a pretty good knowledge of the enterprise as a whole, and there are a lot of tradeoffs we have to explore, and again, we have some experiments going on in effect, doing operational auditing of internal audit departments. I expect to be able to publish the results of this work late this year, and I can say at this stage of the experiment it looks promising.

It is very easy to become pessimistic about the state of affairs in accounting today. There is a lot wrong and the trouble is that too many people know it. We are getting a bit of pressure. We are getting pressure from three different places; pressure from the regulators, we are a regulated industry. We have been a regulated industry for some period of time. When you are in a regulated environment, you must respond to the needs of your public, and in the regulated environment it means that the regulators themselves have a role in directing activities and shaping the way the practice occurs. Part of the pressure comes from management of our clients. The pressure comes in this way. As the requirements grow, some changes have

occurred in the auditing profession. We now have quarterly reporting and, belatedly, the AICPA has recognized that you can give a positive report on a corporate review. We now have an obligation to report publicly on the state of our client's internal accounting controls. Our clients have, or soon will have, things like replacement costs and other disclosure variations. If you look at that in retrospect it is a big piece to bite off and it is a whole lot to chew. The remarkable thing about our system is that we are able to do it in one way or another. One of the ways we are going to be able to do it is by strengthening the effectiveness of the overall function, the audit function, which includes two parts, internal and external audit activity. Outside that we are looking how in 4-5 years one thing that is going to happen is that the internal audit portion of that function is going to undergo a significant change. We will raise the level of professionalism. We will have given them specific assignments that they will have to perform in the corporate entity, and we are going to raise the position of the internal audit function in the corporate environment. It goes without saying that all of these things will impact directly on the relationship between the internal auditor and external auditor, but that is the subject of another talk. The result of this raising of the level of the internal audit function is to respond to these new responsibilities with what, I think is a reasonable sort of increase in the cost of the overall audit function. I include in that the cost not only of the internal audit function but the cost of the external audit as well. And the reason we must do that is that the audit function itself is the subject of a social contract and that social contract is that the cost must be less than the benefit. So basically what I would say is take some satisfaction. We've had great steps up in the requirements that have been imposed on us both inside and outside and we've been able to deal with it in a way that meets our test, that is the benefit will exceed the cost.



MR. SAM YELLEN

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FEDERAL REGULATION OF THE ACCOUNTING PROFESSION

as presented by

MR. SAM YELLEN

I have been trying to develop a common theme for the students, financial men, and practicing accountants who are present. The only common thread we have is that we're all accountants and auditors of sorts. Classical definitions of the auditor appear inappropriate. Considering the student aspect of the concept, I decided to look into philosophy books. A philosopher who was popular in the early part of the twentieth century seemed to have the answer; his name was Elbert Hubert, and I would like to share his definition with you:

"The typical auditor is a man past middle age. Spare, wrinkled, intelligent. Cold, passive, noncommittal, with eyes like a codfish. Polite in contact, but at the same time, unresponsive, and damnably composed as a concrete post or a plaster of paris cast. A human petrification, with a heart of feldspar and with the charm of a friendly germ. Minus bowels, passion, or a sense of humor. Happily, they never reproduce and all of them finally go to hell!"
Was he that far off?

Public accounting developed in an era of quiet obscurity. The public's perspective reflected a similar view. The public viewed auditors as the individuals with green eye shades who added nonexistent precision to financial statements. This, although untrue, was the popular conception. Or, stated differently, the public thought we added the Good Housekeeping Seal of Approval to financial statements and that, too, was wrong. This perspective continued until 1933 when the SEC was formed, which became one of the first significant influences on the profession. In 1933 the SEC looked at the accounting profession and its initial reaction was to reject us.

Initially, the SEC planned on forming a cadre of government auditors, who would audit public financial statements but, after some deliberation, concluded that independent auditors should be permitted to audit and report upon public companies' financial statements.

The SEC has been a major influence on the accounting profession,

communicating with the profession through a vehicle called, "Accounting Series Releases." During the era of 1933 to 1973 their conversation with that profession was quiet and soft. In that 40-year period, the SEC issued approximately 120 Accounting Series Releases -- three per year, which was not a phenomenal production. The SEC communicated with the profession, the profession listened, and a good working relationship existed.

Sandy Burton joined the SEC in 1973 as Chief Accountant. At this point the quiet tranquility changed dramatically. Although Sandy has now left the SEC, the pace he set has continued. Between 1973 and the present, the SEC has issued approximately 130 Accounting Series Releases. Instead of the average of three per year, they have averaged 40 per year. In addition the SEC has issued less authoritative pronouncements -- Staff Accounting Bulletins, of which there have been about 25 or 26.

The SEC's charge has been to monitor "fair disclosure." The SEC disclaims setting accounting principles and, in fact, has so stated publicly in Accounting Series Release 150. That statement is correct... I will give you examples supporting the notion that the SEC does not establish accounting principles!

Several years ago companies were becoming involved in a novel transaction. They were exchanging existing debt bearing a low interest rate for debt with a higher interest rate but a lower principal amount -- a simple transaction. Under the clean surplus theory, the differences in principal had to flow through the income statement. The accountants had rules for that type of transaction. The recorded difference was not an extraordinary item by our rules and accordingly was recorded as ordinary income. The SEC objected to the instant ordinary income that was appearing in financial statements. The accountants claimed that since it was permitted by the accounting rules they had no choice. The SEC stated they understood the difficulty confronted by the profession. In an attempt to resolve the problem the SEC would require extraordinary treatment for early extinguishment of debt. The profession objected to dual accounting principles. The debate continued until the accounting profession issued a new pronouncement requiring extraordinary accounting for early extinguishment of debt. Getting back to my original premise, the SEC does not establish accounting principles; the Accounting pro-

fession does.

The SEC next became involved with interpretations of prior period adjustments as permitted under APB Opinion 9 and began to interpret the Opinion in a manner that essentially eliminated most prior period adjustments. Members of the profession and company management disagreed with the interpretation. One client carried its disagreement beyond the SEC Staff to the full Commission. Under the appeal process, the Company prepared a position paper in support of the notion that the transaction with which it was involved was a prior period adjustment. The position paper had to be given to the Chief Accountant, who forwarded it to the Commission. The Company was not given access to the Staff position paper nor was it permitted to attend the Commission hearing although the SEC Staff was present. The Commission agreed with the Staff position, resolving the matter.

However, the variance in interpretation of APB Opinion No. 9 as to prior period adjustments continued. Eventually, the subject of prior period adjustments was placed on the FASB agenda. In time the FASB issued a draft pronouncement which ostensibly eliminated prior period adjustments in their entirety. The SEC concurred with the conclusions of the draft FASB pronouncement. However, the FASB encountered a problem in issuing the final pronouncement. The five affirmative votes required for issuance couldn't be mustered. The SEC stepped in and issued the essence of the FASB draft pronouncement as a proposed SEC Release, as a result of which the accounting profession became concerned with the potential for dual standards existing. The matter was eventually resolved in a simple manner: the FASB changed its voting requirement, requiring only four affirmative votes to issue a pronouncement. Again, my original theme is supported: the SEC does not establish accounting principles.

However, there is one instance where it is possible to conclude that the SEC has set accounting principles. For years, accounting literature has permitted dual optional accounting for interest -- capitalization or expensing. The SEC focused on this issue and issued a release that attempted to rectify the companies, was that companies which disclosed they had capitalized interest in the past could continue to do so; companies which had not disclosed interest capitalization in the past could not capitalize interest in the future. This is somewhat contorted

logic, in that prior disclosure permits one principle while nondisclosure mandates the use of another principle. Since "disclosure" wasn't defined, however, inquiries were made to the SEC as to whether it referred to footnote disclosure only. The SEC responded that any disclosure would suffice. The result was that companies searched their files for press releases and parts of annual reports were reviewed to determine whether there had ever been disclosure of interest capitalization. The culmination of all this is a somewhat illogical accounting principle. If the company is public and has disclosed anywhere that it capitalized interest, it can continue to capitalize interest. On the other hand, if a company has not disclosed that it has capitalized interest it cannot continue to do so or adopt the policy. If a company is private, it can either capitalize or not capitalize interest.

Another interesting situation arose which related to New York City "Big Mac" bonds. The SEC wanted the bonds written down because of the city's perilous financial condition. The New York banking community stood up to the SEC and mounted a strong campaign against the suggested approach. The SEC backed off and agreed to require only disclosure of the breakdown of the various series of bonds.

Another interesting topic at the time was replacement cost accounting. The accounting profession was suggesting current value accounting. The SEC, on the other hand, was thrusting for replacement cost accounting. Although the subject was debated extensively, a bit of a standoff resulted. This continued until the accountants in England issued a pronouncement entitled the Sandilands report that opted for replacement cost accounting. The SEC took this pronouncement as the tie breaker and adopted replacement cost accounting on an experimental basis.

The SEC required disclosure of assets, inventory, cost of sales, and depreciation on a replacement cost basis, although the SEC cautioned that the data should not be brought down to the net earnings or earnings per share level because they recognized that other items would be affected if companies ever went to full replacement values. These included plant capacity and new technology.

In spite of the caution, investment bankers brought the disclosed data down to the net earnings level and published the results as replacement cost accounting net earnings. Some interesting notions evolved. Comparing

replacement cost accounting new earnings, lower than historical earnings, with historical dividend payments caused the erroneous conclusion (because replacement cost accounting earnings were lower than dividend payments) that substantial numbers of companies were in liquidation.

The SEC involvement with oil and gas accounting warrants comment. For many years two forms of accounting existed in the oil and gas industry. Full cost and successful efforts accounting were both acceptable. Full cost accounting permits the capitalization of dry holes drilled under certain conditions. Under successful efforts accounting, only successful drillings are capitalized. Generally, large oil companies use successful efforts accounting and smaller, developing oil companies use full cost accounting. The smaller companies claim a change to successful efforts accounting would eliminate much of their net worth and prevent them from going into the capital market place. Congress issued a mandate to the SEC to formulate a single form of accounting. The SEC, in turn, assigned this task to the FASB.

The FASB held extensive hearings and eventually issued FASB 19 which accomplished what Congress wanted -- a single form of accounting for oil and gas: successful efforts. However, this pronouncement resulted in an uproar by the smaller oil companies and pressure was put on Congress. The SEC then came up with its own pronouncement which permitted both the existing methods (full cost and successful efforts accounting) to continue and added a new notion called the reserve change method. In an attempt to avoid a conflict with the SEC, the FASB withdrew the effective date on FASB 19. The FASB pronouncement exists in accounting literature, but without an effective date.

The discussion to this point has related to accounting principles. I think the point I have attempted to make is that the SEC does impact the establishment of accounting principles but does not establish them.

But the SEC has also become involved with the auditing or nonauditing process. It has issued a proposed release that would require quarterly data to be included in the footnotes to the annual report. The accounting profession objected because the proposed release would not permit the data to be labeled as unaudited in the footnote. The SEC responded that it wanted the accountant to be associated with the data, although it didn't necessarily require that the data be audited. The SEC then issued a

proposed draft of suggested review procedures to be used in concert with the accountant's association with quarterly data to be included in footnotes but labeled "Unaudited." In time, the AICPA issued its own review guidelines and the SEC withdrew its suggested guidelines.

Leaving the SEC and moving on to Government's impact on the accounting profession, in the post-Watergate era newspapers were replete with commentary about improper payments, bribes, kickbacks, management fraud, corporate failure, etc. Congress got into the act and asked, "where were the auditors?" The Metcalf Subcommittee, the Moss Committee, and the Proxmire Committee came into being and proposed legislation controlling the accounting profession. Pressures on the accounting profession grew.

At this point I would like to share a story with you about the farmer and the city slicker. The farmer is explaining that to gain the attention and cooperation of a mule, you have to speak to it gently. By way of demonstration, he lifted a 2x4 and hit the mule squarely on the head. "Why," said the city slicker, "did you have to hit the mule with a 2x4 if gentle talk gets the best results?" And the farmer answered, "First you have to get the mule's attention." Parallels? Congressional efforts were about as subtle as a 2x4. The accounting profession has been known at times to be slow and on rare occasions perhaps stubborn. And the actions of Congress got the accounting profession's attention, to say the least. And the accounting profession responded.

The AICPA has been divided into two sections, the SEC and the private section. Members of the SEC section must comply with requirements for professional education, peer review, sanctions, and reporting of financial results. The activities of the section are under the review of a new overseeing board.

Congress also has responded and come up with the Foreign Corrupt Practices Act (FCPA). If we focus on the acronym (FCPA (to the uninformed it can erroneously be taken for "Federal CPA")), it appears the notion may relate to the initial SEC desire for a cadre of accountants. Actually, the FCPA establishes requirements for companies to maintain adequate internal accounting controls.

The SEC reported to Congress that the profession should be given a chance to prove its effectiveness for self-regulation and control. Both Congress and the SEC will continue watching the profession. The FCPA will

be the vehicle for increasing audit committees and implementing more independent boards of directors.

What does all this mean and where does it take the profession? The SEC will continue pressing for expanded services by the profession. The profession will get involved with projections and attesting to internal controls. Accountants will be heavily involved with soft data published by public companies. The SEC's attempt to influence accounting principles will continue. The profession will have to be cognizant of public opinion and will be operating in a fishbowl. The profession will have to develop the respect of its critics. It will be a never-ending task facing future graduates into the profession. The profession's image will have to improve. What is going on is like making love with a gorilla; one can't stop because he's tired.



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Mr. Isaacs spoke on the topic:

"THE FUTURE IMPACT OF THE REVOLUTIONARY CHANGES IN
COMPUTER TECHNOLOGY ON THE ACCOUNTING PROFESSION"

Because of technical problems Mr. Isaacs' speech was not transcribed. Below is an outline of his presentation.

I. Trends in computer technology

A. Hardware

- . Time line of electronic computer hardware developments
 - 1946 First electronic digital computer (vacuum tubes)
 - 1959 "2nd generation" (transistors)
 - 1964 "3rd generation" (integrated circuits)
 - 1970 Micro processors
 - 1975 Interchangeable firmware
- . Trends in auxiliary memory
 - Cards
 - Tape
 - Disks
 - Mass memory
- . Trends in communications
 - Land lines
 - Microwave
 - Satellite
 - Fibre optics
- . Trends in terminals
 - Teletype
 - Typewriters
 - CRT
 - Graphics
 - Intelligent terminals
 - Computers as terminals
- . Cost trend
 - 1968 system costing \$1 million was less than \$250,000 in 1978 dollars
 - This is a reduction factor of 8-10 (considering inflation) for greater capability

Software trends
(A major increase in intellectual access to the computer)
Machine language
Assemblers
Compilers
Database management
Telecommunication

B. System processing modes

- . Evolution of processing modes
 - Unit record
 - Batch processing
 - Remote access
 - On-line processing
 - Distributed processing
 - Multi-system network
- . Cost implications
 - Terminal-hour cost for an on-line system is now less than person-hour cost, and gap is widening
 - This implies more on-line processing

C. What does future hold (5-10 years)

- . Voice input of transactions
- . Very inexpensive mass memory (E.G. "bubble memory")
- . "Problem-solver" software languages
- . "Standard parts" for application software
- . Household terminal input
- . Cost-effective text input and retrieval
- . Equalization of communication costs for any distance

II. Evolution of business systems

A. Applications

- . Early development of financial systems separate from engineering, manufacturing, inventory control
- . Trend is toward integrated applications

B. Functional control of information processing

- . Early development decentralized functionally
- . Later under controller or chief financial officer
- . Trend toward information executive

III. Future impact of the new technology on business systems

A. Continued shift away from repetitive manual steps

- . Evolving obsolescence of:
 - Key data entry
 - Typewriting
 - Manual bookkeeping entries and balancing
 - Indexing, filing and retrieval of hard copy
- . Greater emphasis of human work on:
 - Voice data transcription
 - Problem identification and solution
 - Personal interactions
 - Supervision and management
 - System development and improvement

B. Greater accessibility to more generalized computer capability

- . For the general public
 - Increased familiarity with computer externals through access to available consumer systems
 - Increased emphasis on computers in formal education
- . For the business person
 - Increased accessibility to computer power through high level languages
 - Increased isolation from intricacies of computer hardware and software
 - Increased difficulty in supervising technical specialists
- . For the computer specialist
 - Greater degree of specialization
 - Greater emphasis on tool development
 - Easier, faster developmental cycle
- . For the accountant
 - Decreased amount of time spent in manually tracing errors
 - Easier use of audit support software
 - More removed from intricacies of computer internals
 - More difficult to audit effects of detail transactions
 - More difficult to audit software development process
 - More difficult to control versions of software being used

C. Needs in immediate future

- . Address problems of random software auditing
- . Standard testing and "seal of approval" for externally supplied firmware
- . Extensive ongoing education process for accountants in details of computer technology
- . Establishment of quality standards for system developments using advanced technology

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