

My judgment would be based somewhat upon what I observed in the way of internal check and control and upon the procedure followed by the company in its internal audit and the company's own procedure as to sending out its own confirmation requests during the year.

In the small-loan business, which is quite similar to installment houses, in that there are a large number of small items, it is quite common for small loan companies to send out their own affirmative type of confirmation requests on various sections of the accounts to the extent that they may confirm practically all of them during the year. Those companies do not let up on any confirmation request merely because they can't get a reply. If a reply is not received, the company's own auditor may go out and call on the party to find out what the situation may be. I believe that the mechanical job of sending out confirmation requests to 80,000 or 100,000 different individuals is so tremendous that if the internal control is good and the company does send out its own confirmations, it is hardly necessary for the auditor to send out confirmations.

Q. Now, referring to the small-loan business there. Is that generally conducted through a series of branches?

A. It is.

Q. With their own branch manager somewhat divorced from the main office?

A. They are very much divorced from the main office, although the better companies maintain, to some extent, duplicate records in the main office and the better managed companies have their own traveling auditors who check up pretty well on the branches.

D. INVENTORIES

Q. Now, turning to inventories, Mr. Lenhart. In your opinion is an accountant responsible for the pricing of inventories in accordance with accepted accounting principles?

A. Well, I believe the accountant should be satisfied that the inventory has been priced in accordance with generally accepted accounting principles. Just what might be meant by responsibility, I am not quite sure, but in any event whether he has something to do with the original pricing or not, I think he must arrive at a conclusion as to the satisfactory pricing.

Q. If a determination of market prices is necessary, for example, in connection with cost or market, what is meant there by "market price"? What procedure do you follow to ascertain that the market price actually used is applicable as to quantity, quality, grade, and so forth?

A. Well, in my opinion, market price means as to raw material, the price at which the particular quantity of materials might be purchased on or about the balance sheet date. As to goods in process or finished goods, I believe market price means the lower of reproduction or replacement price and estimated selling prices less applicable selling, shipment, and other direct selling expenses. There is some doubt in my mind as to the applicability of replacement prices in the case of goods in process or finished goods. For example, I think it may be possible for a low cost producer to produce a finished product at

such a cost that he could make a margin on the cost to a high cost producer. It might be conceivable that a high cost producer would go out and attempt to replace his inventory from a low cost producer.

On the other hand, if all market prices are declining and the client receives offers from other people to replace inventory items at figures lower than the cost to the client it may be desirable and conservative to use such lower replacement figures even though the client would not be apt to actually buy from such source to replace his inventory.

With Chevrolet cars it would be very difficult to go out and get somebody to give you a replacement on those, so about the only thing you have left is a reproduction market price. The procedures we employ are to review published market quotations, trade journals, quotations received from vendors, purchase records, cost records, sales records, general market conditions, and such knowledge as we can obtain of general market trends and conditions. It is difficult in many lines of business to identify a particular quality in an inventory and I think there that we are dependent somewhat upon our knowledge of the quality which is necessary for the clients to use in order to produce his product. If we knew that a cotton mill customarily used one grade of cotton, and suddenly found the inventory full of a much higher grade, I think we would then be suspicious that he didn't have such higher grade.

Q. What procedures do you follow, Mr. Lenhart, in determining that goods held, or shipped, by the company on consignment have properly been treated in the inventory?

A. In many cases we review the inventory procedures before the inventory is taken, inquire as to how the company proposes to handle cut-off as to goods on hand and on consignment and have representatives present during the taking of the inventory. We also ask for confirmations from consignors or consignees as to goods held or shipped by the company on consignment. Correspondence, shipping documents, and so forth are also sources to be used in connection with such determination.

Q. Do you ask for confirmations from consignors and consignees with which the company is accustomed to deal, even though the records show no balances?

A. We have no fixed rule on that but we would be apt to ask for them if there had been any volume of transactions at all.

Q. Is it customary for you to make any other tests to determine whether or not the company, in fact, owns inventory which you know to be on hand?

A. Well, we always expect the auditor to be alert enough to note any indication in the records which might cause him to suspect that inventories on hand are not the property of the company. The kind of business, the standing of the company, its past record, all such things, have some bearing upon the auditor's concern as to whether any goods on hand are actually owned by the company. We usually find some trace through the records, particularly if you check a month's transactions in detail, that would cause you to either believe or disbelieve that the goods were all the property of the company. Also, we customarily make inquiry of officers and employees and obtain inventory and liability certificates signed by responsible officials of the company. I think all of us have found by experience that a man

recollects things sometimes when he signs a statement that he didn't recollect before he signed it, and by and large we don't find very many omissions of material matters in those certificates we receive.

Q. What is your procedure to determine that there have not been included in sales, goods which were shipped during a subsequent period? I think you may have answered that in part already.

A. I think in substance we review the inventory procedures, in many cases are in attendance when the inventories are taken. We know what the customary procedure is. We find out how they determine tag numbers and shipping department numbers just up to the inventory date and starting thereafter and make enough inquiry to find out that they have made proper cut-off.

Q. I made inquiry to shipping records, I believe, earlier. Now, in examining records for this purpose, what do you look for on the records themselves?

A. Well, we would try to match up shipments with particular items on hand. If there is any way to trace by number or by identification any of the merchandise on hand, we would make sure that those items shipped just before the balance sheet were not also included in the inventory.

Q. Do you modify your procedure in any respect when the goods are shipped from a warehouse not under control of the company?

A. Well, the procedure is modified in this way, that we then would ask the warehouse as to the last items shipped, for some description as to what was shipped, and to whom it was shipped with respect to the last items before the inventory date.

Q. Would you look for, in connection with your examination of documents, under this procedure, look for the dates? Would that be a significant item?

A. The dates would be one of the most significant items you could see.

Q. Now, in verifying the accuracy of inventory footings, and extensions as made by the company, do you feel that it is feasible or desirable to employ comptometer operators?

A. You don't restrict that to comptometers?

Q. No; it is a class of mechanical device.

A. I do sometimes think it is desirable. I have had engagements where we have continuously used comptometer operators for a period of weeks with the result that we could much more quickly check calculations and footings than we could have checked them any other way.

Q. Do you see any disadvantage in the practice?

A. I do not see any disadvantages providing you have sufficiently capable operators, of sufficient integrity to do their work properly.

Q. What inquiries and tests, Mr. Lenhart, is it customary for you to make to determine that purchase invoices for stock included in the inventory have actually been entered on the books and the converse case?

A. We would usually try to match up shipments received during the last few days with the purchase invoices entered. On the other hand, we would take purchase invoices received and try to find when those items actually were received at the plant or when they were actually shipped, if they are to be included in goods in transit. The

effort really is to try and match the inventory against the purchase invoices.

Q. What records do you examine in that connection?

A. I think we would examine receiving records, any record that the company might have listing purchase invoices received. We would look in the inventory or stock-keeping records, possibly in the correspondence files, in some cases.

Q. Now, if the procedure outlined in the bulletin as to inventories has been satisfactorily completed, is it your custom to include in the accountant's report, or the statement, a qualification as to your responsibility for the quantity, quality, or condition of inventories?

A. We do not customarily include in our report a qualification regarding something concerning which we have no qualification. We believe our responsibility for the quality, quantity, or condition of the inventories varies largely as between different types of business. If we make what we consider a reasonable investigation of the quantity, quality, or condition of inventories, we see no reason why we should need put any qualification in our report. I think there again we would decide for ourselves what would constitute a reasonable examination. If we were examining the accounts of a mining and smelting company, we might look ourselves blind and see huge piles of ores, with no knowledge as to what the value might be. We would be more apt in that case to make all the reasonable tests we thought necessary of book records and production records and feel then that we had done all that we reasonably should do. In some other cases we might feel that a reasonable investigation would require being present when the inventories were being taken.

Q. In case the accountant's report or the statements indicate that the auditor had relied upon responsible officials for information as to quantity, quality, or condition, do you feel that this avoids the necessity of making any of the tests which are referred to in the last sentence of item 3 which—I might read that—

make reasonable inquiries and tests to ascertain that quantities have been carefully determined, and that quality and condition have received due consideration.

That's at the top of page 18.

A. I am not at all sure that this condition would arise in our practice. We, at one time, felt that disclosure that we did not do something relieved us of responsibility. We have come to feel that if what we didn't do was something we should have done, we are not very much relieved, and, as a matter of fact, we make it worse for ourselves by saying we didn't do something we should have done.

On the other hand, if we had been permitted to make what we consider a reasonable investigation, we see no reason for stating that we have relied upon responsible officials for information as to quantity, quality, and condition of inventories if, in fact, we have not relied only upon such information. Now, in any case, whether physical tests are made or whether they are not, if we feel that we have made what, under the circumstances, is a reasonable investigation into inventories, quantities, and pricing and what not, we see no advantage in the company indicating in its statements either that the inventories are as certified by company officials or in our indicating in our certificate that we have relied on that sort of a representation.

Q. What do you do when you have not been able to make a test which satisfies you as to its reasonableness in these points?

A. If the amount involved is not such as to materially affect the statements we might make a qualification and possibly give some indication as to the amount involved. Our feeling with regard to any material difference is that we should not certify the statements.

Q. I believe you have indicated that you customarily make a review of the methods the company follows in taking inventory. Would you indicate briefly, what you consider to be the important points in a satisfactory method of taking physical inventory, also indicate how you determine whether such points have actually been followed?

A. That's question 84?

Q. Yes.

A. We review the methods followed by the client in taking the inventory. We think it important that the inventory be first carefully counted and tagged and that a second crew count with the same care as the first crew that pulled the tags. We like to observe the actual inventory-taking to see that the count is carefully made, that all tag numbers are accounted for before being issued, that all tag numbers are accounted for after the inventory is taken and that the summaries are carefully made and all computations carefully made, and checked.

Q. Is the count of the first crew available to the second crew at the time they are counting?

A. I don't think there is any fixed rule. Sometimes it is, sometimes it isn't. The second crew is really checking the count of the first. I see no great disadvantage in having the count available to them. On the other hand, there is the same situation there as in connection with receiving records. If you tell a man what he should be receiving, he might count less carefully and put down the number he should receive rather than the actual number. I would think you would get the most accurate counts by not making the count of the first crew available to the second.

Q. Is that customary, do you know?

A. I really couldn't say.

Q. You stated that you reviewed the procedure purported to be followed. How do you establish that that actually was followed or the observance by the client of those points?

A. Do you mean in the event that we are not present at the inventory?

Q. Yes.

A. We generally satisfy ourselves by examination of the original inventory sheet and by talking to a sufficient number of people who actually participated in taking the inventory. It is rather difficult for a large number of people to tell the same erroneous story and I think if you make enough inquiry you will be able to satisfy yourself as to the methods which were used.

Q. Now, when you observe the inventory-taking, what do you do there? I mean, what does your observation consist of?

A. We generally would watch some of the counts being made. We would make our own count of a test number of inventory items, keep a record of our counts with the identifying tag numbers and would check those counts against the inventory when summarized.

We would make a record of the tag numbers issued and the tag numbers taken back and assure ourselves that all tag numbers issued were actually taken back and accounted for.

Q. In appraising the accuracy and integrity of the inventory, quantity, quality, and condition, do you ascertain and give weight to the nature of shipping, receiving, and stockkeeping records? And if you do, what is your view as to the significance of the independence of the people performing these functions?

A. We do give weight to the nature of the shipping, receiving, and stockkeeping methods. We think it adds materially to the reliability of the inventory records if shipping, receiving, and stockkeeping are handled by different departments and the various persons performing the duties under the three classifications are independent of each other.

Many companies nowadays maintain very accurate book records and check physically the book record of each kind of stock either as the stock becomes low or from time to time and we feel very much greater assurance if the book records are obviously so accurate that the physical counts should vary but little from the book records.

Q. In the case you do not observe the inventory taking, what do you do if you feel that the methods followed by the company are not satisfactory on the points you have just mentioned?

A. Well, we might do any of a number of things, up to the point of insisting that a later inventory be taken and worked back to the balance sheet date.

Q. Which you would observe?

A. Yes.

Q. In your opinion should an auditor be reasonably familiar with the products manufactured or dealt in by a company?

A. I think he should.

Q. Is it your practice to make spot tests of any portion of the inventory by actual count or inspection?

A. It is not our invariable practice nor is it our practice in the sense that we always try to do it wherever we might be able to do it. We have some cases in which we may have made physical tests for some years and ceased making physical tests.

I know of one case where the nature of the business is such and the control over the various branches and plants around the country is such that I would rather rely upon the book inventory record than I would a physical count.

The quantities involved are yards and the control is so tight that we devote all the time we used to devote to checking physical quantities to checking the accuracy and reliability of this book record.

Q. Is it your practice to make any over-all tests as to inventory such as warehouse capacities, insurance coverage, tax payments, average production and consumption by the company, domestic imports and so forth?

A. Yes; it is our practice to make any over-all tests which we believe would afford us any additional assurance as to the integrity of the inventory quantities. If we have quite extensive test counts, I doubt we would do a very great deal in the way of over-all tests and the kind and extent of the over-all tests would depend upon the nature of the business and related circumstances of the case.

Q. What do you have in mind by over-all tests? I have listed a few. Were you agreeing with those or do you use some others?

A. Where are the ones you listed; No. 88?

Q. Yes.

A. I think the ones we make most frequently would be quantities at the beginning upon some basis plus purchases less production and sales to try and arrive at quantities at the end, but that may be used in such businesses where there is a unit of product. A gross profit test is one that is rather frequently used when it can be effectively used. We don't make any particular comparison of warehouse capacities, but I do recall cases in which we might have been told that certain bins, for example, held a certain quantity and we knew that it just wasn't possible to get that quantity into the bin. I think we would rely somewhat on what we felt was a normal amount that a business should have; for example, in the case of a chain grocery store, we would make a rough and ready test as to what a store of a certain volume should have by way of inventories and if the inventories varied materially from that, I think we would want to know why.

The tax payments, if they are directly related to the amount or quantity of inventory we might use.

Insurance coverage, I doubt if we would use that as any very exact method as to what the inventory might be. Of course, if we found that there was a great difference between insurance coverage and inventories I think we would inquire as to why that would be the case, but I don't think we would rely on insurance coverage as indicating the quantity of inventories that a company might have.

Q. You mentioned the gross profit test and if it could be effectively used, you might employ it. What did you have in mind there?

A. I have in mind where there is a great variety of products and profit margins on the product vary widely, it is a rather difficult thing to use the gross profit test whereas if you have only one product or if you can break it down by departments, you can generally either find a satisfactory explanation for a variation in gross profit or else you come to the conclusion that the inventory is wrong.

Q. That would be your purpose to test the inventory by that method?

A. Not entirely. I would use the gross profit test to explain to my satisfaction any significant changes in gross profits which might indicate that some of the expense accounts were wrong or that the cost accounts had been padded or money might apparently be spent for purchases of material which was in fact stolen; something of that kind.

Q. What evidence do you customarily rely upon to verify the quantity of merchandise held in independent warehouses or at vendor's warehouses?

A. We customarily rely on confirmation both with regard to independent warehouses and warehouses of vendors and up until recent times we have regarded that as much more preferable than physical count for the reason that a physical count is nothing but that, whereas confirmation from an independent warehouse or a vendor means that not only does somebody independently tell you that the goods are there but that somebody else is responsible in connection with cases where they are not there.

Q. Do you make any individual examination or test of their financial responsibility in those cases?

A. Customarily not, but in case of vendors we ordinarily know who the vendors are, either through reputation or a long record of dealing with the vendor. I don't believe that I could say that we customarily make any investigation.

Q. Would the procedure you are accustomed to follow disclose whether the vendor had misappropriated the goods?

A. No, I don't think so. If the vendor tells us that he has 1,000 units on hand, that he is holding for our client, we wouldn't find out that he had stolen them. We would also be reluctant to go up and look at them because if we go up and look at them the vendor can then say that we relied on our own count and there were only so many there, whereas if we take a confirmation he can't say anything other than he said, "I had so many" and that he was responsible for them.

Q. Do you make any other type of test of quantity or quality or condition that we haven't discussed?

A. Yes, we make any tests of quality, quantity, and condition of inventories that may seem desirable to us to help satisfy ourselves that the inventory quantities are reliable.

There are an infinite number of things that may come up or occur to you which would indicate the kind of tests that might be made. I can well recall the purchase of one of the most successful manufacturing companies in the country according to its record, and after the purchase it was found that a reasonable check-up on inventories would have disclosed that they were hopelessly out of date and in many respects unsaleable and in many respects the raw materials were unuseable.

Q. Looking to the future, Mr. Lenhart, would you make any modification in the procedures that auditors should follow as to verifying these items?

A. Well, if I were trying to get the utmost in audit fees and if I were trying to go as far as I could in the ultimate verification of the last detail, I would go farther than auditors generally now go.

At the same time, I think, giving weight to the cost of the service and the results that are accomplished day after day with the procedures now used, I think that no particular change is necessary.

Q. What do you think of the participation of the auditor in taking inventories or by observation?

A. I think in many cases it is a very desirable thing. As I indicated a while ago I think that in some cases it is either useless or entirely futile for the auditor to try and do anything with counting an inventory.

Q. Even to supervise taking of it?

A. Even to supervising the taking of it, if it is the type of inventory like a mine or smelter where he could go out and do all the supervising and they could either double or triple the inventory while he was standing there and he wouldn't know anything about it.

Q. In the cases where observation would be valuable, do you think that that would add significantly to the cost of the audit? What has been your experience rather as to that?

A. I feel this way, that in the case of very large companies, if we try to survey all the spots and make an extended observation, it would add materially to the cost.

On the other hand, what I find is that ordinarily the company permits you to make tests or observations at such points as you may select. I think that if you do that you satisfy yourself that things are being done properly at the point you select and make some variation in the points you select, I think you have got some basis of being satisfied on inventory methods.

Q. You would apply the method of sampling to the process of taking inventory?

A. I would?

Q. Under the rules as to forms it is required that you state in connection with inventory the basis of determining the amount. You indicated a few minutes ago that there were several bases of market. Are there similarly different methods of computing cost, such as, for example, first in-first out, as opposed to last in-first out?

A. To my knowledge there is no end to the infinite varieties of methods of computing costs.

Q. In view of the fact that both of those terms, cost and market, are subject to different methods of computation, would you think it might be desirable to have an indication of what method is followed?

A. I think that perhaps the general basis might be indicated although even there I do not believe it adds much. I think you would get into trouble if you tried to go too far in indicating the basis used.

I believe that of all places where judgment comes into play, the question of whether the inventory basis affords a fair basis of stating inventory is one of the most important. An auditor may decide that the inventory basis is all right, but that some further disclosure should be made. For example, as to what the inventory may amount to at market.

I think the question is very much a live one right now because of the change on the part of many companies to this last in-first out inventory method.

The question is still open as to whether under that method you should also apply the test of selling price or market price. You have the question as to what disclosure should be made if under that method you get too far below what current replacement price might be or what current selling price might be.

Q. If there had been any change in the method, should that be disclosed? For example, you used average one year and then you change to last in-first out?

A. I think it should be disclosed although I had one yesterday which was changed from first in-first out to last in-first out in a company which made \$2,000,000 and it made a difference of \$15,000 in the amount.

Q. If significant, let us say. It is possible, is it not, that the application of alternative methods of determining costs might make a large difference in any one balance sheet?

A. That is true. The consistency in practice is the thing of primary importance.

Mr. WERTZ. Shall we adjourn?

The EXAMINER. Yes, we will recess until 2 p. m.

(Whereupon, at 12:30 o'clock p. m., a recess was taken until 2 o'clock p. m.)

AFTERNOON SESSION

Q. (By Mr. WERTZ.) Mr. Lenhart, there are one or two matters I think we might clear up for the record, as it went this morning. You referred in your testimony to the custom of banks of block deposits. If such a practice were followed by a bank, what auditing procedure would have to be followed in order to disclose irregularities by the cashier? Would your customary procedures be satisfactory?

A. Well, I think in the first place if a man consistently made his deposit slips agree with his cash book, although he might be depositing items which differ from the cash book, we would not be apt to catch anything by merely comparing deposit slips with the cash book entries.

Q. And the reason for that would be what?

A. The reason would be that the items on the deposit slip would agree absolutely with the items on the cash book.

Now, any man who is making deposits with false items listed on the deposit slips would always be taking a chance that the bank might not be able to balance that particular day, and when the bank came to check back the items deposited against the deposit slips, the bank, of course, would find that they didn't agree and might report it to some one who would disclose such a lack of agreement between the deposit slips and the items deposited. One way that has been suggested in a discussion before this last question was that many banks today take photostatic copies of both the back and front of every check deposited to the credit of an account or sent out for payment through an account, and if there was any real doubt it would probably be possible to obtain photostatic pictures from the bank of any checks actually put in for deposit on that particular day, and that would undoubtedly clearly establish whether the man was lapping his receipts.

Also, if the auditor makes a second reconciliation of the cash, the employee of the client is never on notice as to what day that is to be done, and he would probably be under considerable pressure as to just how to handle this cash so as to be ready for such a second reconciliation.

Customarily, in making that second reconciliation the auditor would check over the deposits and the deposit slips on the day on which he made the second reconciliation and he would be apt to pick up anything wrong in that way.

Q. One other question: Referring to your discussion of the question of confirming accounts receivable, I don't believe it is clear in the record as to what your practice has been in the past on that point.

A. I would say that we have been making either test confirmations or, rather, extensive confirmations of accounts receivable for a great many years to a very small degree. I believe that starting about 10 years ago there has been a fairly good growth in the practice. About 2 years ago, as far as we were concerned, we attempted to

send out at least test confirmations in the cases of a majority of our clients. I would say today that we have very few clients left who offer any objection to test confirmations with the possible exception of retail stores and there the problem is pretty bad as to how to send out confirmations, as to how much you might accomplish and the amount of resistance which might be received from customers.

Where we have attempted it we have spent a great deal of time explaining why their ice box wasn't delivered and the various things they came in to see us about and it is quite a problem from our point of view as to how wise it is to try to circularize these.

E. OTHER BALANCE SHEET ITEMS

Q. May we go ahead on some other items on the balance sheet. Referring to item 4 on page 21 in connection with property, plant and equipment, how do you determine the amount capitalized as additions to plant represent real additions and improvements?

A. I don't believe that sentence in the bulletin means what it said. I think what is meant is that the auditor should determine that the amounts capitalized represent items which are considered to be capital expenditures such as additions and improvements and not items which from their nature properly should be considered chargeable to expense.

It is not customary for the auditor to make an appraisal or detailed inspection of the plant; however, in the case of major additions, the auditor sometimes satisfies himself that such major additions have been made.

Q. Referring to the bottom of page 34, how do you ascertain that plant units have been abandoned and should be removed from the asset account? Do you make any physical verification of major items in the books which have apparently been fully reserved against?

A. Well, we make specific inquiry on that point in the case of every engagement and often we ask for and receive a letter covering the items which have been abandoned or scrapped.

The auditor will often find indications in the records indicating that plant units have been abandoned. Expense vouchers, receipts from sales of plant items, changes in the records relating to manufacturing activities, etc., are indications that there may have been abandonment or removal of plant units.

I don't believe the auditor customarily makes a physical verification of major items which the books reveal are nearing the end of their estimated lives, provided there is no indication that such items have not already been abandoned.

I think that, by and large, the auditor does more than he thinks he does in ascertaining whether there have been any important items scrapped or sold, because of variations in production, his inspection at the time inventory is taken, the fact that the same men to some degree go back and would have some recollection of what was there last time would all be helpful in picking up any abandonments.

Q. You say inspection at the time inventory was taken. Do you imply there that the auditor should inspect the physical plant?

A. Well, I think that in connection with any tests of inventory, a man necessarily must get a reasonably good idea of the plant layout, at least enough so that he would remember any major change.

Q. In the absence of making physical tests, would he make some physical inspection of the plant for that purpose, do you think?

A. Not necessarily, I wouldn't think.

Q. Now, turning to insurance for a moment, what procedures do you follow in verifying the allocation of insurance charges between periods, and do you use the information obtained for any other purposes?

A. As a part of our check of the accounting methods and procedures, we customarily make inquiry of and inspect policies for insurance coverage. If the client maintains an insurance department, we may confine ourselves to tests of the company's computations of insurance coverage and allocation of insurance charges to future periods.

We make inquiry regarding the insurance coverage as investments change as to classes and locations of merchandise.

However, we do not regard it as one of our duties to act as insurance experts. If we receive what we consider to be satisfactory explanations with regard to under- or over-coverage of insurance, and if we are satisfied as to the computation of the amount of insurance premiums deferred to future periods, we consider that in the usual case we need go no farther.

There may be exceptions, of course, such as in an investigation for credit purposes, for new financing, etc. We have been approached from time to time by insurance experts, particularly since the recent matter that is the subject of this inquiry with the thought that it might be a part of an auditor's duty to go pretty actively into the question of insurance coverage, but we have felt that it would be a very bad mistake for us to try to go into such thing.

Now, it isn't at all infrequent that in an audit report of a long type, we may point out what appears to be inadequate insurance coverages or over-insurance, but we have never felt that beyond bringing it to the attention of the management, that we need do any more in the usual course of events.

Q. Now, referring to page 24 of the bulletin, item 2-C there, it reads:

Make a test examination of monthly statements received from creditors having large balances.

What do you consider to be an adequate test in that connection?

A. I would certainly consider as adequate a test in which the auditor saw and checked to the account monthly statements representing 50 percent or more of the dollar amount of creditors' accounts.

Q. You say "saw and checked" to the individual accounts. Is that the type of examination you have in mind?

A. Yes, I think that merely looking at the creditor's statements would do you no good unless you saw that the amounts were in agreement with the client's records. I don't think the checking of these creditor's statements is essential, particularly if we confirm creditors' balances as we do in quite a number of cases.

Q. In the absence of confirmations, would you feel the test was a desirable one?

A. I would think so.

Q. On page 8 again, there is a requirement as to the approval and entry of vouchers being made by others than the disbursing officer. What is the significance of such a requirement?

A. I think the effect of the requirement is that it materially adds to the strength of the internal check and control if approval and entry of the vouchers are made by others than the disbursing officer.

Q. Is that, then, another illustration of the segregation of duties that you referred to before?

A. Yes.

Q. Do you expect your regular auditing staff, Mr. Lenhart, to have a general knowledge of the types of taxes which impinge upon the business, that is, both domestic and foreign taxes?

A. We do expect our auditing staff to be familiar with all types of domestic Federal taxes, and in the case of each office, the major types of local taxes.

In that connection, our firm issues at least once a year a memorandum of some size outlining each Federal tax, and in the case of New York, each local tax, with a description of the tax, how it is computed and the period to which it applies and a statement as to what the firm policy may be with regard to accruals or deferment of some part of those taxes.

We expect the auditing staff either to have or to obtain a general knowledge of the principal types of foreign taxes which may be applicable in the case of any client. That sometimes is a rather involved procedure. I remember in the case of the British income tax it took us 3 or 4 years to understand in this country how it was computed and the period to which it might apply in the case of subsidiaries of American companies.

Q. What procedures do you follow, Mr. Lenhart, in determining the existence and amount of contingent liabilities, and what responsibility do you take in connection therewith?

A. Well, we expect the auditor to be alert to note anything that may be disclosed by the examination of the client's accounts which might indicate the existence of contingent liabilities; correspondence, by payment of legal bills and such items, may give indications of unrecorded or undisclosed contingent liabilities. We customarily obtain a liability certificate from a responsible officer of the company which includes a representation as to any contingent liabilities.

It is our feeling that the auditor is never entitled to go along with the statement that there are no contingent liabilities. Our feeling is that omission of any contingent liabilities from a balance sheet means that there are no contingent liabilities of any importance.

We do feel that as far as we can reasonably go, we are responsible for uncovering anything that should be uncovered by reasonable investigation.

Q. Do you discuss this matter with counsel for the company?

A. We not only discuss the matter with counsel, but we customarily refuse to take the responsibility of deciding for ourselves whether many of these law suits may or may not involve the company in any particular liability.

We feel that if the lawyer will not hazard an opinion it is very difficult for us to have one. Lawyers today are quite ready in most cases to give us a letter doing the best they can to state what in their opinion the liability may be, and whether they think the suit has any merit or may involve a real liability.

Q. Do you customarily include a qualification as to the existence of contingent liabilities? That is, do you make any reference to the fact?

A. In our certificate?

Q. In the certificate or otherwise?

A. No, with the exception that we do have some cases where instead of our making any mention in the certificate we satisfy ourselves that the provision for contingent liabilities is as nearly adequate as anybody can make it, and we have persuaded the client in some cases to make a footnote stating flatly that until such time as certain matters are settled or until certain tax claims are settled, it is impossible to state whether such provision as has been made is adequate or excessive.

Q. In connection with this, do you examine the minutes of various corporate bodies such as directors, stockholders, operating committees?

A. We make it our invariable practice to examine such minutes early in the course of the audit.

F. PROFIT AND LOSS ITEMS

Q. Now, turning to the profit and loss statement, Mr. Lenhart, on page 30, item 1 suggests that a working profit and loss statement be obtained or prepared in as much detail as is reasonably available. For this purpose, to what extent would you obtain and utilize financial analyses and statements which the company has prepared?

A. We attempt to make the fullest use possible of statements prepared by the company. In many cases, we furnish the company with our working papers and ask that the analyses be made on that paper in such form as they may be useable for our work as well as the company's work.

We feel that it is very much to the advantage of the company to spend the time in preparing these analyses so that our time may be devoted to checking the analyses and the accuracy of the information stated thereon.

We also, of course, make use of all monthly statements or any other statements which may be prepared by the company in comparing the trend of items month by month.

Q. Do you inquire of the company to find out what statements they have available?

A. Yes, we do.

Q. Now, in item 2 under the same topic, what is the purpose of obtaining budgets, previous annual statements, and the monthly statements? What investigation do you make; what use do you make of these statements?

A. Since most examinations today are confined largely to the balance sheet with limited tests to the income account, we attempt to form some judgment as to the general integrity of the accounts and also some judgment as to whether there are any unusual fluctuations by comparing actual amounts with budgeted amounts, comparing this

year's statements with last year's statements, and even comparing statements month by month, this year, with corresponding months of the previous year. Quite often you run across changes which seem significant and sometimes you are able to uncover something that needs further investigation, and in any event you do gain a much better knowledge of what may be the reasons for changes in the income account.

Q. When your study discloses significant changes, do you make investigations to determine the reasons therefor?

A. We do.

Q. Item 3 under sales and cost of sales, outlines a procedure for testing allowances to customers for returned merchandise, claims, and rebates. What, in your opinion, is the importance of such an analysis?

A. I think it has two purposes. First, in connection with any investigation we may be making of the system of internal check and control and, secondly, as a part of our investigation to determine the apparent integrity of the income account classifications as to sales, deductions for allowances, cash discounts, and such items.

Q. Do you always make such a test?

A. I do not believe we have any rule that we must always do it. There, again, I think it would depend somewhat upon the possibility, in our minds, of something being done to misstate those items.

Q. Now, turning to the general profit and loss statement for a moment. What, in your opinion, is the responsibility of the accountant for the correct classification of income and expenses? How do you go about satisfying yourself in that respect?

A. We do not feel that the auditor has any great responsibility for exactness of the classifications of income and expense. We believe he should make reasonable tests and that if his tests indicate that the classifications are carelessly made, or that they are so far wrong as to get a misleading picture, we would no doubt either refuse to go along with the classification or would insist upon doing sufficient work so that we might know rather definitely whether the classifications were right or wrong.

Q. Do you examine large charges individually as well as making sampling tests?

A. We would ordinarily scan through the accounts and if we saw any items of unusual size or if an account runs out of proportion to what we might expect, we would look into it.

V. REVIEW OF THE ENGAGEMENT

Q. Well, now, I would like to turn to the question of reviewing the original work in the audit program. In your practice, Mr. Lenhart, who is responsible for drawing together the results of the detailed program and preparing the preliminary statements?

A. In our practice the supervisor is primarily responsible, although the senior who is on the engagement might do most of the actual work in drawing together the audit basis in preparing the financial statements. The supervisor is required not only to review all working papers, but he must initial every sheet.

Q. When you say "all working papers," do you mean the working papers completed by the juniors as well as the senior on the job?

A. I mean every working paper that we put into our files, relating to the engagement, must be initialed by the supervisor.

Q. And does he review in detail as to that?

A. That we hope, and I think some judgment is exercised there.

Q. Is it customary to have the statement reviewed by any person other than the man who first draws them together in your practice? Perhaps you would rather answer that by just outlining your general review procedure.

A. The only review made in addition to that already indicated is a review by the partner. The extent of review is dependent upon several things; one, the character of the engagement, whether the partner believes that there are apt to be items concerning which the supervisor is perhaps in some danger of going wrong. The partner quite frequently visits the client's office during the engagement and reviews some parts of the work at that time.

In some cases the partner may feel that the engagement is of a character so that a rather superficial review of the working papers is sufficient, but he always makes a very careful review of the statements and particularly asks a great many questions as to how the work was conducted, and the basis upon which various items may be stated.

Q. Is there any one who checks the supervisor on tying in the statements, back to the working papers? As I understand it, the supervisor draws up the financial statements himself, or with the assistance of a senior?

A. That isn't quite right. I believe what I said, the supervisor is responsible, but the senior who is on the engagement actually does most of the work of drawing together the audit data and preparing the financial statements.

Then, the supervisor would check the senior's work and the partner probably would not check the clerical accuracy but would do a good deal toward checking the statements.

Q. I see. What would you say was the purpose or intention of such a system of review, Mr. Lenhart?

A. Well, the fundamental purpose is to make sure, as nearly as we can, that the audit has been conducted as nearly as possible in a manner in which a partner might have conducted it had he been on the engagement himself.

VI. THE REPORT OR CERTIFICATE

Q. Now, turning to the accountant's report, or certificate. What class of persons in your firm are authorized to sign a certificate, or report, and would they draft it in the form of that certificate?

A. Well, no one is authorized to sign a certificate or report, or even a letter, except a partner, or if we have no partner in an office, then the manager of that office is authorized to sign.

Q. That would be a specific authorization to that particular individual?

A. It would.

Q. Is it your practice to use a certificate along the lines of that set forth on page 41 of the bulletin?

A. It is.

Q. What do you understand to be the function of the accountant's certificate or report?

A. I believe the function of the accountant's certificate or report is to express in very general terms the scope of the examination made and his opinion with regard to financial statements.

Q. What impression do you attempt to convey by that form of certificate?

A. Well, the impression that we attempt to convey is that if the certificate is unqualified, we believe the balance sheet is a fair presentation of the position of the company and that the statements of income and surplus fairly set forth the results of its operations.

Q. Is it your understanding that the second sentence of the certificate is intended to be a reasonably comprehensive description of the scope of the audit?

A. I believe it is a very general statement, but at the same time a reasonably comprehensive statement as to the scope of the examination in conformity with good accounting principles and practice.

Q. Do you believe that any material omissions from the program indicated in the bulletin should also be indicated in the certificate, in describing the scope of the audit?

A. If an accountant is willing to omit something which should not be omitted, I suppose he ought to indicate it, but it would be our feeling that if something is omitted which should not have been omitted, we would not sign the certificate.

Q. Do you believe the certificates should contain any limitations contained in the audit engagement?

A. Such limitations as what, for example?

Q. Well, let me approach this a different way. Do you ordinarily have your audit engagement in the form of a written contract?

A. I would say that in most cases we have some sort of letter or written statement which represents the first agreement. For some time we have been endeavoring to go on record with the client with some exactness as to the scope of the examination we are making from year to year, its limitations, if any, as to disclosure of defalcations and have tried, to the best of our ability, to make sure that the client understands fully just how extensive our examination is as to possibly uncovering things that might be wrong in the accounts during the year. We have our own form of engagement memorandum which outlines in general the terms of the engagement.

Q. Would that be prepared irrespective of this other document?

A. That is prepared irrespective of the other document. The last document I speak of may be written more than once; that is, it may appear to us advisable every year, or every second year, to write a letter to the client, especially if we are writing about any matters of internal control and procedure in order that we might again advise them as to the scope of the examination.

Q. Now, in such a document, you say there might appear limitations on the scope of the audit which were reached by agreement with the client?

A. If that is what I said, I didn't intend that. What we try to do is to make clear any limitations there may be as to the possibility of our work disclosing defalcations or uncovering each and every item that is wrong during the year. We find that too many people

consider an audit as an audit and nothing else, that no matter how often you tell them that a balance sheet audit will not uncover defalcations, the minute one is uncovered they are surprised because they are having an audit made, so we believe it is to the client's advantage, to the advantage of the board of directors and greatly to our advantage to have very clearly on the record such a statement as we can make that while a balance sheet audit covers many things, it doesn't necessarily mean that we will uncover every case of defalcation or understatement of assets or irregularities, if there were any irregularities.

Q. If there were any limitations in the scope of the audit reached by the client, would you anticipate that those did appear in the description in the scope of the audit included in the certificate?

A. I think the best answer to that is that years ago we made audits which had definite limitations such as we were not to examine physical inventories. We came to the conclusion some years ago that it was highly dangerous for us to go along with that kind of work and by now, I think, that while we may have, I cannot think of a single case where there is a limitation on the engagement that would stop us from doing what we think we should do to certify.

If we don't certify, merely make a report for internal use, then we feel somewhat differently; we may limit our work in almost any respect as long as it is clearly understood that we don't sign a certificate.

Q. I see. You mentioned there that too many people consider an audit was an audit. Do you have that same feeling as to people who read certificates or use the statements accompanied by a certificate?

A. Yes; I think there is almost universal lack of understanding on the part of people who don't happen to have familiarity with what accounting work is supposed to do.

Q. Have you any suggestions as to improvement along that line?

A. I haven't. I certainly wouldn't want to give everybody an accounting education in order that they could understand the certificate.

Q. Referring to the certificate. What language in there indicates that there has been no material change either in accounting principles followed or in the manner of their application as compared with the preceding period?

A. The only statement in the certificate which might mean that is the one—is the phrase—

consistently maintained by the X Y Z Co. during the year under review.

It is my understanding that while it doesn't say so, that this always refers to consistency with the preceding period.

Q. Do you think some change might be advisable in that language?

A. I think now it might be. At the time it was first written there were some reasons which made it seem inadvisable to write it differently, but I think the time has come when there is no good reason for not indicating that it is consistent with the previous year.

Q. Now, looking at the introductory statement as to the accountant's report. I believe that indicates that data may be included in the accountant's report or in the statements for the purpose of being merely informative to state limitations on the scope of the accountant's work or to indicate dissent from particular practices of the

company. How is a reader able to distinguish as to particular matters between the purpose for which it is included?

A. I must confess that in the past there have been many certificates which were so worded as to make it impossible to tell whether the statement was information or an exception. I think the only answer is to make the certificate so clear that there is no possibility of misunderstanding.

Q. Would you consider that the description of the limitations and the scope of the audit in the scope paragraph with a qualification upon the opinion expressed by virtue of the language based upon such an examination?

A. Not necessarily.

Q. What effect would that have?

A. To my mind, the only effect of putting in the first paragraph some limitation without further reference to it would be to indicate that the accountant felt that even though he had not been permitted to do something, or did not do something, nevertheless he was able to express an opinion with regard to the statement.

Q. Would you say that matter contained in the body of statements proper or in the footnotes thereto was merely informative or represented qualifications, or what?

A. I do not believe it could ever be anything other than information, although we see some things in some statements that make us wonder just what they are doing.

For example, I think we have certified statements in the past, as well as other firms have certified statements, and in the balance sheet there appeared the words "inventory as taken by the company."

Now, I don't believe that is information because there is no balance sheet that is ordinarily put out but what the inventories are taken by the company itself. I do not think that comes under the heading of either information or qualification.

Q. If you wanted to express a qualification as to, say that point, where would you put that in your certificate?

A. In the last paragraph of your certificate and the position in which I would put it would depend upon whether I wanted to qualify consistency of practice or qualify the character of the accounting principles followed or whether I wanted to qualify my opinion as to whether the statement sets forth the position and results of operation.

D. Do you imply you might be able to express there an unqualified opinion even though principles have not been consistently followed?

A. Yes. For example, in metal companies or companies which may use inventory methods somewhat different from the ordinary, we might make an exception that the accounting principles followed are not strictly in accordance with the particular principles which we might say are generally followed, but nevertheless we might feel that the balance sheet is a perfectly good balance sheet and the profit-and-loss statement fairly represents the results of operations.

Q. Might you also qualify as to the consistency of application without qualifying your opinion on the financial statements?

A. Yes. We frequently make qualification where a company makes a change, usually for the better, as a parenthetical expression imme-

diately following the word "consistently," making it clear that the qualification relates merely to the consistency of practice.

Q. If you wanted to qualify your opinion, where would you place that?

A. I would place it either immediately after the words "in our opinion," or else at the end of the last paragraph.

Q. With an expressed statement?

A. Yes.

Q. I would like to refer now for just a moment to the instruction in Form 10-K as to the accountant's certificate. There is a paragraph in there that states that in certain financial statements independent public, or independent certified public accountants, may give due weight to an internal system of audit. Did that expression, in your understanding, include a system of internal checks and control, as used in that paragraph and do you so interpret it in your work?

A. I would not think so.

Q. How do you interpret that sentence as it applies to your work under these acts?

A. Do you mean what is the effect of this in our practice?

Q. Yes.

A. None whatever.

Q. Do you feel that that sentence prevents you from relying on a system of internal check and control because it mentions internal system of audit?

A. My feeling would be that this is merely recognition of something that an auditor is entitled to do if, in his judgment, he should place reliance on the client's own audit.

VII. GENERAL SUGGESTIONS AND COMMENT

Q. Now, Mr. Lenhart, we have had a suggestion made that corporations should rotate the firm of auditors at frequent intervals. Have you any opinion as to the desirability of such a practice?

A. Well, I believe it would be undesirable from the standpoint of expense, because we find that sometimes it costs us twice as much to make the first audit as it does succeeding audits and if it became a customary thing to rotate, I hardly believe that any firm could absorb that additional expense, with the result that the client would undoubtedly pay more for the audit work. Also I think it would be undesirable for the reason that in a great many businesses there is so much to learn about the past history of the company and its operations that a client might not get as good service as it would by retaining one audit firm. I think it would be far better for corporations to select competent auditors and retain them.

Q. If you succeed another recognized firm as auditors, do you feel that you have to go back into the prior work to the same extent as if you were coming into a new job that had not been audited?

A. That depends a great deal upon the competence of the previous auditors. If we believe they are competent, we feel that we need do very little as to going back into prior periods.

Q. In such cases do you make any exception or qualification in your report on the company to the effect that you have relied on work of these other auditors?

A. We don't, because we feel if we shouldn't have relied we should not have, and if we were entitled to rely on it, we need say nothing about it.

Q. Is it customary, Mr. Lenhart, for representatives of your firm to appear at directors' meetings at which the audited statements are presented?

A. It is not customary although at times we do appear at directors' and stockholders' meetings if we are asked to appear.

Q. Do you think that is a desirable practice?

A. Well, I can see no harm whatever in it and I think it might have some advantages if the directors would like to ask questions regarding the scope of the work or what the auditor's opinion might be with regard to certain things. I think it is particularly desirable at directors' meetings rather than stockholders' meetings.

Q. Would you expect there that the auditor would be required to answer questions?

A. I would think so.

Q. And how about presenting material on his own initiative?

A. I believe if the auditor had something that he felt should be presented at that time to the board of directors rather than in the form of a written report, I think he might well present it.

Q. In other words, he would have the right to speak as well as to be spoken to.

A. Yes.

Q. Does your firm send copies of the report to the directors in advance of the meeting?

A. Usually we do not. The pressure is so great that we are quite fortunate to get the reports out in many cases before the board of directors' meeting.

Q. Do you think it is desirable and practical to let them have it in advance?

A. Yes.

Q. And let the auditors send it to them directly?

A. Yes. As a matter of fact we are now receiving instructions for the first time in a number of cases that our reports should not only be addressed to the board of directors but should be sent to the board of directors.

Q. How do you carry that out, simply by mail?

A. Well, since our instructions are now coming through for the first time, I don't think we have carried any out. They related entirely to 1939 audits, but what we shall do, undoubtedly, is to find out the names and addresses of the directors and mail a report to each director.

Q. I see. Do you feel that auditors should point out in the statements any significant developments or changes during the period audited, either in the form of a report to the directors or to the stockholders?

A. Well, if the auditor is making a long form of report, I think he should point out anything he believes to be of interest or importance, make any analyses or arrive at any conclusion that he thinks is of interest.

Q. Let's assume the ordinary annual report to stockholders or annual report filed with the Commission.

A. Well, I doubt the necessity of such procedure in most cases. We do have at least one client that sends out to its stockholders a complete copy of our regular audit report.

Q. Do you, yourself, make analyses of the changes there in the form of a statement of application of funds?

A. We customarily make such a statement in the long form of a report. I don't believe we have ever done so for certified statements only.

Q. Do you make such a statement for your own use in preparing the balance sheets?

A. Usually we do.

Q. Now, as to the adoption of the natural business year. Do you feel that that would be a desirable step and how would it assist in improving the audit work?

A. The most important results in my mind would be the fact that the public accountant could maintain an organization of higher ability. It is very, very difficult nowadays to handle the rush-season work for the reason that each concern must take on temporary men. With complexities of business that there are today, the large number of taxes, various regulations that arise, the number of competent men to do audit work is relatively scarcer than it was 10 or 15 years ago. If engagements were staggered so that the public accountant could maintain an even staff, he probably could do much more toward developing a more competent organization which would do better work, possibly take a little more time, undoubtedly could charge the client less, undoubtedly could pay the men more, with better results all around.

Q. Would there be any technical advantages in the point of view of the statement, determination of income, for example?

A. Yes. If each company were to adopt as its closing date the most logical date, they would certainly be able to present a better balance sheet. It would be able to make more effective comparisons with other companies in the same line of business, it would be under less expense to take its inventory and prepare its own financial statements. It will probably have more time to devote to the preparation of financial statements and there would also be corresponding benefits to credit grantors, to commissions, governmental bodies.

Q. Would you say that the allocation of income would be facilitated in view of the lower inventories, for example?

A. Yes; I think it would.

Q. Now, speaking of auditing practice, generally, today, Mr. Lenhart, would you say that it is mostly concerned with determining that generally accepted principles and conventions have been followed in the accounting records of the company?

A. I would not say so.

Q. How would you characterize it?

A. I think that it is concerned with two things of equal importance. First, that the amounts stated are fairly stated, or accurately stated as nearly as can be determined by an examination of the scope made, and, secondly, that the statements are prepared in accordance with the accepted principles.

I think that either one of these things without the other would result in statements which are unreliable. Statements which are

accurate but prepared in accordance with poor principles would certainly be misleading while statements that may be prepared in accordance with good principles, but which are not accurate would be unreliable.

Q. Will you indicate briefly the items in the balance sheet and make statements which your auditing procedure verifies to your satisfaction by tests that are independent of the accounting records themselves or of information which is furnished by officers and employees?

A. Well, I cannot think of any item that is customarily verified in its entirety.

Q. Shall we say established to your own satisfaction?

A. I cannot think of any item that is established to our satisfaction in that way. At the same time, as a part of our examination, or as an important factor in it, we do obtain an independent verification of many items, confirmations of cash, receivables, insurance deposits, amounts of cash or securities in the hands of trustees, accounts payable, stock outstanding, many things are independently confirmed but usually as a part of the examination rather than as a complete verification in itself.

Q. Would you class inventory in that category where physical count or check is made—spot test?

A. No; I would not for the reason that spot test is merely one way of establishing to your satisfaction the integrity of the book records.

Q. Now, the second paragraph of the certificate states that in the auditor's opinion, based upon his examination, the statements fairly present the position of the company and the results of its operations.

When you use this form of certificate, Mr. Lenhart, do you mean that in your opinion, as a public accountant, the examination you have made has been sufficient to verify the existence of the assets and liabilities and the authenticity of the transactions?

A. I do not believe I ever knew of a case in which a public accountant felt, with respect to a company of any size, that he had verified the physical existence of every asset and the authenticity of every operation, nor do I believe it would be feasible for an accountant to do so, short of a detailed audit, with independent and reliable appraisal by some third parties of such items as fixed assets.

Q. Suppose we substitute for "verify" the words "established for your own satisfaction."

A. The existence?

Q. Yes.

A. I think the accountant must feel that there is an existence there, otherwise he would hesitate to certify. Certainly if he felt doubtful as to the existence of the assets, he would go ahead and make further investigation but I think the accountant is in a very difficult position if he feels that he cannot rely on something or if he must make absolutely sure of the truth or existence of something.

Q. Suppose we put it this way: Would you, as an accountant, sign a certificate of this type unless you were satisfied that the examination you had made was reasonable, in your opinion, as an expert?

A. I would not.

Q. And also that so far as this examination disclosed the assets were established to your satisfaction?

A. I would not sign unless I felt that.

Q. Unless both of those were true?

A. Yes.

Q. Have you anything to add?

A. There is just one thing I would like to add.

Q. Please do.

A. In the daily work of the auditor, he encounters frequent cases of defalcation, failure to follow accepted accounting practices and principles, overly optimistic valuations of assets and mistakes of various kinds. All of these matters are discovered by such accounting procedures and practices as now constitute the best practice of the most capable public accountants.

Auditors have found that the vast majority of business men in responsible positions are honest, and that information furnished by them may be relied upon.

I should greatly deplore any attempt to increase the many burdens already placed upon American business men by unduly increasing auditing costs merely because in one case there was dishonesty on the part of officers of the company. I have a very sincere feeling that there will be further changes and further improvements in public accounting practice. At the same time, I do have the feeling that there is some relation between what should be done in the usual case and what should be done in a rare case. To my mind, as in the case of insurance risks, the question always arises as to whether the expense is justified or the risk should be taken. I think that is the case as to the auditing practice followed.

I would distinguish between what might be considered not only the best practice but the practice of a capable man with sound judgment. By that I mean that adherence to all the rules that you might develop, if followed by a man who lacked appreciation of the significance of things he saw, would not do as much as to following of far less rules by a man of judgment and ability.

Q. Your statement raises one question. I believe you indicated that in a great majority of cases one should be entitled to rely upon the integrity and honesty of the particular firm. Does that mean that you make no inquiries or tests to determine whether that exists in fact or not?

A. No; I believe that all through an audit the various steps do prove the honesty of the representations made, but when a man tells you that he does not know of any liability that is not disclosed by the books, I think you should have the feeling that you are entitled to rely on that as a truthful statement.

Q. Does that extend to the field in which you have a ready means of independent check? For example, would you rely upon that for determining the amount of cash in banks?

A. I would not. I would rely on it as to those matters which might be very difficult of detection by the ordinary means, such as the existence of contingent liabilities or things of that kind, as I would expect to rely on it as to the consistency of the general conduct of the affairs of the company. If I made tests of one month's transactions and believed the officials of the company honest, I would feel that I was entitled to rely on their word. On the other hand, if I tested one month's transactions and believed officials to be dishonest

I would not feel that I was in a position to do anything other than to say I found they were honest for one month.

Q. What was that last statement again?

A. I said if I checked one month's transactions and yet I believed the officials dishonest, I believe the most I could do then would be to say that as to that one month they were honest.

Q. To the extent you have indicated would you say that the audit is to check upon the management as well as upon the employees? That is, to the extent that you go ahead and verify individual items independent of information from the officers and directors or employees?

A. You mean check on the integrity?

Q. Yes.

A. I believe so.

The EXAMINER. Have you anything, Mr. Henderson?

Mr. HENDERSON. No.

The EXAMINER. Thank you very much, Mr. Lenhart.

Mr. WERNTZ. Thank you very much, Mr. Lenhart.

The EXAMINER. We will adjourn until 10 o'clock a. m. tomorrow morning.

(Whereupon the hearing was adjourned until 10 o'clock a. m., March 1, 1939.)