

BEFORE THE SECURITIES AND EXCHANGE
COMMISSION

In the Matter of McKesson & Robbins, Inc.

OFFICES OF THE SECURITIES AND EXCHANGE COMMISSION,
120 Broadway, New York, N. Y., Wednesday, March 1, 1939.

Met, pursuant to adjournment, at 10 o'clock a. m.

PROCEEDINGS

The EXAMINER. Mr. Mathieson, will you be sworn?
Whereupon:

JOHN K. MATHIESON

was called as a witness for and on behalf of the Commission, and being first duly sworn, was examined and testified as follows:

The EXAMINER. Mr. Mathieson, will you give the reporter your full name and address?

The WITNESS. John K. Mathieson, Philadelphia, Pa.

The EXAMINER. Mr. Mathieson, it is customary at the Commission hearings to apprise a witness of his constitutional privileges. You have the privilege of refusing to answer any question if you believe such answer will tend to degrade you or subject you to fine, imprisonment, or forfeiture. That privilege extends to each and every question that may be propounded to you.

I. AFFILIATIONS AND BACKGROUND

Q. (By Mr. WERNTZ.) Mr. Mathieson, will you state your present firm affiliation?

A. At present I am a partner of Mathieson, Aitken & Co., practicing accountants in one office in Philadelphia.

Q. How long have you been a partner?

A. I have been in public practice since 1912 except for war service. Prior to 1917 I was with Lybrand, Ross Bros. & Montgomery, in their Philadelphia office. As of May 1, 1919, I helped form a firm of accountants which was dissolved in 1929, our present firm of Mathieson, Aitken starting at that time.

Q. Prior to going into public accounting, Mr. Mathieson, had you any educational training in accounting?

A. Well, in the early years of Lybrand, Ross Bros. & Montgomery I took a course in the University of Pennsylvania in the evenings and finished that course in 1915.

Q. Are you a certified public accountant?

A. I am a certified public accountant in Pennsylvania, and have been for 20 years.

Q. Could you indicate, briefly, the size of your firm?

A. Our firm is comprised at present of approximately 40.

Q. And number of partners?

A. Four partners.

Q. Do you have any branch offices?

A. We have no branch offices.

Q. Could you outline roughly the type of clients, or type of business that you serve?

A. The type of client, practically speaking, is a smaller corporation arising either from the standpoint of credit investigation through bank request, from the standpoint of investigation for trust estates and banks who acquire businesses that they have to operate, of companies which are largely owned by the management or closely associated stockholders, and of investment houses, members of the New York Stock Exchange, and quite a number of banks.

Q. Are those clients in any particular type of business?

A. They are generally diversified, mostly manufacturing and financial, but covering, I think, almost every type of business in existence.

Q. Are you a member of any of the professional societies, Mr. Mathieson?

A. I am a member of the Pennsylvania Institute of Certified Public Accountants, the American Institute of Accountants.

Q. Do you hold any offices in those groups?

A. At present I am a vice president in the American Institute of Accountants, and I am in both associations a member of a number of committees.

Q. Could you indicate some of those committees?

A. In the American Institute I am a member of the executive committee, committee on cooperation with the Securities and Exchange Commission, the committee on accounting procedure. In the Pennsylvania Institute, I am the chairman of the committee on professional ethics.

Q. Have you published any works on accounting; articles?

A. I have written a few articles, given a few talks. I have published no books as such.

Q. Have you engaged in any teaching activities?

A. I have not.

II. SCOPE OF EXAMINATION OF FINANCIAL STATEMENTS

Q. Can you indicate, and distinguish, Mr. Mathieson, the types of accounting services which you render which lead to, or result in, the certification of financial statements?

A. Annual examinations of corporations for the stockholders, examination for credit purposes, particularly in our case for banks, special investigations for some purpose, possibly a security issue or something of that kind.

Q. Do you classify there the different types of audit, for example, the detailed audit as opposed to the more restricted type?

A. The detailed audit is not accomplished very often today. The usual audit is the balance sheet examination with the test of the operating accounts sufficient to satisfy the accountant that the statements

of the financial condition and operating results are substantially correct.

Q. What type of service do you render in connection with preparing these annual reports? Is it the examination type or is it the detailed audit, or what?

A. Primarily the examination type.

Q. Are you familiar with the Commission's exhibit 117, the examination of financial statements?

A. I am.

Q. Did you, or any of the members of your firm participate in the preparation of this pamphlet?

A. I was asked to review it by the committee that prepared it. I was not on the committee itself.

Q. In your opinion, what was the purpose of publishing such a bulletin?

A. To bring up to date the bulletin previously issued in 1929, put out under the auspices of the Federal Reserve Bank, to record the changes and conditions that had happened in the intervening period in order to acquaint the accounting profession, generally, with what minimum of accepted practice would be and to acquaint financial officers of corporations, credit agencies, banks and exchanges as to the general character of work included in an accountant's examination.

Q. Among the types of service rendered by your firm, how would you class the examination contemplated by this bulletin?

A. A general trend; a minimum rather than a maximum to be extended, not contracted.

Q. In these examinations, would you say that the principles of the bulletin are of general application to all types and sizes of companies?

A. The principles are; yes. Size is simply change of volume rather than principle.

Q. In your own practice, do you use or follow this bulletin as a guide?

A. We use it as a general guide. Every man on the staff is required to be familiar with it.

Q. I believe you said a moment ago that, speaking generally, you regard the examination described in the bulletin in the nature of a minimum rather than a maximum.

A. That is correct. It is not applicable in detail in every case. It has to be applied to the case but as a minimum guide.

Q. Putting it this way: If you left out those steps which are—which were inapplicable because the conditions were not present, would you feel the remaining procedures were in the nature of a minimum?

A. Yes; I would, generally.

Q. Would you say that in general the examination by your firm is more extensive, or less extensive, than that contemplated by the bulletin?

A. I would say more extensive in the main.

Q. Speaking historically, did the publication of this bulletin lead to changes in your own practice, or do you know whether it led to any changes in auditing practice in general?

A. With our own, it is hard to state anything definitely. I think it undoubtedly resulted in a tightening up by having some attention

called to procedures that were set forth, that might be taken as a matter of course. We reexamined our own procedure to see that we were conforming and not forgetting something which was in there, and I think that was probably true of the profession generally, although I can't speak for others.

III. OFFICE METHODS AND STAFF ORGANIZATION AND TRAINING

Q. Now, the next question I would like to have you distinguish, if you will, between practices that you followed prior to the present case, that is, the McKesson & Robbins case, and those which may have been adopted since that time.

When a client comes to you, Mr. Mathieson, do you make any independent investigation of his credit rating or reputation?

A. Generally, no. Our source of client is from other clients or from financial institutions. I recall very few cases where we have had occasion to look up a client who might have come in without introduction.

Q. If he comes in without introduction, or with an introduction which simply says that—which doesn't give him a reference, what is your procedure there?

A. We are careful to determine why he wants our services, the purpose he expects to make of them, and we want to know some surrounding factors concerning their operations.

Q. From your experience, whom would you say exercises the prerogative of appointing auditors for the purpose of publishing annual reports to the stockholders?

A. Generally the management.

Q. Are you referring there to companies with publicly held stock or privately held stock, or both?

A. Both.

Q. When you accept an engagement, Mr. Mathieson, what representative of your firm determines the scope of the audit to be made?

A. Partner in every case.

Q. Is the scope of the audit reexamined annually in the face of a continuing engagement?

A. It is always reviewed before proceeding with the next one; yes.

Q. From your experience, whom would you say decides questions as to the scope of the audit on the part of the client?

A. Usually a top officer, the president or treasurer.

Q. In such engagements as we are discussing, to whom would you say your primary responsibility runs?

A. We consider it the board of directors representing the stockholders and so direct all our reports.

Q. That wouldn't be true in the case of a special investigation?

A. Not if the work arose at the request of a bank, the report might be made to the bank, although generally there it is made to the directors and they in turn give it to the bank.

Q. Looking to the future, Mr. Mathieson, do you feel there should be any change in the method of selecting auditors or fixing the scope of the audit?

A. I think the accountant should be appointed by the board of directors, preferably, which board would recognize the problems

of its management, that the accountant should have access throughout the year to records and books instead of at one time at the end of the year and he should be free to—really free, to make his report to the directors.

Q. That implies, I take it, the appointment of the auditor at the beginning of the year?

A. That would be preferable.

Q. Otherwise, the privilege of examining records during the course of the year wouldn't be very valuable?

A. Wouldn't be available.

Q. Now, turning to your own organization. Do you classify the members of your staff as seniors, juniors, or something of that kind?

A. We classify them as juniors, semiseniors, and seniors.

Q. And above that, partners?

A. Partners.

Q. When you accept an engagement, how do you determine what partner and what seniors and juniors shall work on the job?

A. Availability, primarily. Familiarity with the type of business as far as the senior is concerned, if possible the juniors, too, if we can do it; but men who, in our opinion, would be capable of doing the work.

Q. How about the partners?

A. Again a specialized knowledge, the partner who has that knowledge, if not, the partner who is available to take it.

Q. Are these assignments permanent for successive audits?

A. To some extent they are, but we try to rotate the men themselves on the work for two purposes; one, to get different ideas of the men and, second, to have men available that are familiar with the client's work in the event that an accident or something might happen to another man.

Q. Are you referring to juniors, seniors, partners, or what?

A. On juniors, we definitely rotate. On seniors, we attempt to make the change every 2 or 3 years, if we can.

Q. And as to partners?

A. We have tried to exchange jobs between partners but that's a little harder, because a partner has become acquainted with a lot of problems of the business besides accounting and generally the client wishes to discuss these problems with someone a little familiar and it is harder to make the change.

Q. Do you feel there are any disadvantages in your policy in this connection?

A. The ideal is probably not attained but we feel that the advantages we get outweigh the disadvantages.

Q. What might be some of those disadvantages?

A. Familiarity might lead a man to accept something which he has seen in the past without too closely investigating it, to see if any change had occurred in the intervening period. Changing men too often, changing too many men on the work, would tend to increase the cost of the work, and tend to possibly irritate the client's employees who would be put out by having to give their time to help you find things.

Q. How do you go about recruiting your juniors for your permanent staff?

A. We have only one staff and that is a permanent staff. Primarily we take the men from college and train them ourselves.

Q. You have no temporary employees?

A. We have no temporary employees.

Q. Do you look for any particular qualifications in the college training; that is, accounting courses or the like?

A. We look for the qualification of education, primarily a course in the university, specializing in accounting. We want personality, appearance in a man, ability to present himself to good advantage.

Q. Is there a definite requirement as to his having had some educational work in accounting?

A. We, in most cases, require it. We have taken men from college who haven't necessarily majored in accounting.

Q. Now, in respect to the men that are placed on your permanent staff, particularly the juniors, do you have any further requirements as to education: self-education, reading, and so forth?

A. We have a practice of periodic meetings, except in the busy period, at least every month, which are led by men familiar with particular kinds of business or by a partner, which these juniors, and to a large extent, the entire staff are invited or required to attend. There are also discussion groups with the juniors who are not busy where we require research work or investigation on certain subjects we may assign them to.

Q. Is the attaining of a C. P. A. certificate essential for advancement in your firm?

A. Generally, it is, and we encourage the men to take the examinations as soon as we feel they are qualified or under our C. P. A. law in Pennsylvania they may do so.

Q. Now, could you describe, briefly, the type of duties which you assign to juniors?

A. A man may be a junior for a period of 2 or 3 years. If he hasn't shown signs of developing in that time, he would be no longer on the staff. His first year would be what we term "labor," verifying footings, getting papers that are required, and books, helping on postings, being primarily the assistant to the senior in charge of the work, being given such work to do that we feel his training or experience with the theory he has would qualify him to do under close supervision.

Q. Would you feel that this type of duty requires knowledge of accounting?

A. It requires a basic theory of accounting which we consider him to have had at college.

Q. Now, speaking generally, from what sources do you obtain your seniors?

A. From our juniors.

Q. Is that—

A. That's our infallible rule. We have made it a practice not to take on men to put over other men.

Q. What qualifications do you look for in a senior?

A. Basic educational qualifications that we require in the junior, plus adaptability, a very definite indication of inquisitiveness, and, naturally, desire to know what is going on, ability to express himself,

to meet people and to intelligently approach the problem which he may have in this particular assignment.

Q. Can you describe briefly the type of duties which you assign to seniors?

A. A senior would be in charge of the field work of the investigation or examination. After discussion of the work to be performed with the partner before the examination commences, he would be told approximately what ground it covered. We depend upon his ingenuity and what he may find largely on the examination. He would direct the work in the field, he would write the draft of the report, prepare the statements and drafts for review with the partner later.

Q. Where does the semisenior that you have indicated fit into this picture?

A. The semisenior on big work would be the man between the junior and the senior who would take over special analysis or possibly special departments if the corporation was large enough, investigating those departments. We might have two or three semiseniors with one senior on one job or he might be in branch offices.

Q. On a large job, would you have more than one senior?

A. No; on a large job you would have, in addition to the senior, pretty close attention of the partner himself.

Q. Do you consider it a part of the senior's duties to train juniors and semiseniors under him?

A. Definitely.

Q. How is that to be done, or how is it done, rather?

A. By telling them what to do. By seeing what they have done, by explaining the purposes and reasons for doing it, by encouraging the junior in his own approach to the problem, both from the standpoint of the records themselves and of general conditions.

Q. How do you satisfy yourselves that the juniors are actually performing the work assigned to them in a satisfactory manner?

A. From the reports of the seniors sent to us.

Q. How do they satisfy themselves?

A. By observation of the work the junior did.

Q. Do they make any test checking of the original document to see that the junior is handling them in the proper way?

A. The junior in his first year on the staff, frequently, yes. After that I would not say that the senior verified in detail the work the junior did.

Q. After the senior feels the junior knows what he is doing, then he merely reviews the working papers he prepares?

A. That is correct. Our men in discussion and association among themselves get a pretty general idea of the capabilities of the various less experienced men on the staff.

Q. Do the partners in your firm participate in carrying out the field work of the audit program?

A. Depending upon the size of the work, yes; I would say that the majority of the time of two of my partners is on field work and Mr. Aitken and myself probably one-third to one-half of our time outside.

Q. Is it a rule in your firm for the partner to visit every client during the course of the audit?

A. It is not a rule. We attempt to do it if for no other reason than the fact of keeping the contact.

Q. Do you see them at other times?

A. Quite frequently, we do.

Q. When one of your partners goes down to a client, what is the nature of his visit; whom does he see? Does he go with a particular purpose in mind, or to supervise his own staff, or what?

A. If the partner is at the client's office during the course of the work he is there to supervise or to determine what is being done on the work, to discuss particular phases of the work that might have been developed or consider questions developed during the course of it.

Very frequently to discuss general problems with the president or treasurer or whatever officers or owners might be there.

Q. On a new engagement, Mr. Mathieson, do you expect the staff assigned on a job to become generally familiar with the trade or industry more or less before they complete the first audit?

A. We do; we encourage our juniors to study the source of products used by clients and the disposition of the products they make so as to be familiar with the terminology used in that business.

Q. And as to the seniors?

A. The seniors having been through that same experience, if they don't know something about the business generally, are required to study up and see what it is.

Q. Do you expect the juniors on the work to which they are assigned to be sufficiently familiar with the type of records and documents they are about to come in contact with so that they may recognize significant irregularities, let us say, the absence of a date on a check or the absence of a signature, something of that kind?

A. We expect them to be familiar with that but if they haven't had previous experience, they are instructed what to look for on a check, for any informalities, lack of date, an old date, improper endorsement; on a mortgage, for the recording stamp or liens, for instance that the lien is not expired by statute, has to be renewed, has been renewed; on securities, that they are in good form, coupons attached to bonds, and so forth, yes.

Q. Would you say generally that you indicate to them points at which irregularities might occur?

A. Yes.

Q. Unless you know that they already know that.

A. We would satisfy ourselves they would know what they are looking for before they were given the work to do.

Q. Do you expect them to be alert to note these irregularities when they are examining documents?

A. We do.

Q. What instructions do you give them as to the course to be pursued when an irregularity is uncovered, do they discuss it immediately with the client, or what?

A. They would discuss it with their superior in charge working with them. If the superior thought it of sufficient importance to take it up with a partner, that would be done before it was discussed with the client unless it was an irregularity on a check dating or endorsement which might be corrected by investigation at the time.

Q. Do you attempt to satisfy yourselves as far as possible as to what is wrong before you take it up with the client?

A. Yes.

IV. CONDUCT OF THE EXAMINATION

A. INTERNAL CHECK AND CONTROL

Q. Now, coming to the system of internal check and control, Mr. Mathieson, to what extent do you require the members of the staff assigned to an engagement to become familiar with the particular concern being audited, that is, the plant lay-out, operating methods, nature of the products, method of doing business, etc. You have answered that, I believe, already in part.

A. We require that they know something of the products; that is, I am speaking now of the senior primarily; the junior is encouraged to, that the company makes such and such products, as well as the products they use in making them. We require they be familiar with procedures or processes through which the product produced goes. In other words, most of our work would be manufacturing and therefore you are developing from raw material to finished products requiring certain operations.

A man should know what is effected by those operations, to know in some relation the costs or the amounts charged to them.

Q. Do you obtain or prepare an organization chart or its equivalent outlining the personnel and duties of each person, lines of control?

A. Very seldom. Our clients are such that we learn those things. It does not seem necessary to put them down.

Q. You don't put them in memorandum form?

A. Very seldom.

Q. Going back to the question of familiarity with a particular business, do you require all of the staff or any part of the staff to examine physically the plant of the client?

A. We make it a point of insisting that at least the senior go through a plant on the first examination, to get an idea of the plant arrangement, how the material is kept, whether the plant is clean, how the plant is kept up, that there is no indication of waste. In my opinion the condition of the plant is an indication of the type of management it has. In such a plant inspection we get a pretty good idea of what we might expect from the books.

Q. What do you understand the system of internal check and control to mean?

A. The balancing of duties on the part of the organization of the client so that important duties are not centered in any one individual, that there is a division of responsibility.

Q. Could you indicate what some of the principal features of such a system are?

A. Well, the bookkeeper shouldn't handle cash. At least, where materials are received it should not be from points at which they are shipped. The invoices for purchases should be, the recording of them should be done by someone other than the person who has occasion to pay for them or draw the checks.

Q. Can such a system always be used?

A. No, it can't. Small businesses would not make that possible.

Q. How would you distinguish a system of internal control from an internal system of audit?

A. An internal system of audit would presuppose a review or verification of what is being done, rather than the plan of doing it.

Q. Would you say that a system of internal audit might be one feature in a system of internal check and control?

A. Yes, it might. On the other hand, you might have a good system of internal check without any internal audit, which is more frequently the case.

Q. You might say it was an optional feature?

A. I would say that having the two would depend upon the size of the business and the volume of transactions going through.

Q. On page 7 of the bulletin there is an indication that the nature and extent of the examination depends on several factors, the purpose of the examination, the scope and amount of detail to be included in the reports to be prepared, the type of business, the accounts which are to be examined, the nature of the system of internal check and control. Would you explain briefly the effect of these factors on the scope of the examination?

A. Those factors are tied in with the purpose of the examination. In our clientele primarily stockholders might be interested. They would be divided into two groups, those active in the management of the business and those who were inactive. The examination may be for credit purposes or it may be a special examination arising out of any one of the number of purposes, either fraud investigation or financial change, the issue of securities or revision of structure.

In those instances where the stockholders are actively in charge of the management of the business, you would not do quite as much with regard to policy matters as you might if management is independent of inactive stockholders. As to bank credit, you would be centering investigation possibly on the earning power today rather than on asset values where a loan is considered, or where the loans existing are a matter of question.

A special examination would be dependent upon what the purpose of that examination was.

Q. How about as to the question as to the amount of detail to be included in the report? How would that affect the scope?

A. There is a minimum of detail required in any event to assure the auditor or the accountant that the records are what they purport to be, and that the transactions entered are substantially correct. If an owner of a business himself is handling sales and determining the credits, we would make less investigation possibly of that end of it, providing there were no financial obligations outstanding which would be a factor.

If the owner specialized in the productive end himself, the engineering, and didn't do much with regard to the sales or cash, probably we would spend more time proportionately of that type.

Q. Does the scope of the examination depend to any extent on how detailed a report you are going to make. Suppose, for example, a detailed classification of profit and loss items as compared to a relatively condensed statement?

A. I would say yes, with the company which maintains an elaborate cost system, there would be no purpose served in breaking that back to get a customary set-up of profit and loss statements, if that wasn't going to be required.

Q. How would you say the nature or the type of the business affects the scope and nature of the audit? For example, comparing a bank with a manufacturing business.

A. Well, in a bank you take very little for granted. You control the assets, cash, investments, loans, until you were through investigating. In a manufacturing establishment where plant cannot be moved and changes cannot be made overnight, you are more apt to take your time.

Q. Would you say that the significance of various types of assets to the whole picture would affect the scope of the audit?

A. Yes.

Q. In what way? For example, compare a utility with very little inventory to a manufacturing concern with a very large one.

A. With a utility the verification of inventory would not be a factor at all except inventory of supplies, which would be controlled by substation or storehouse records that you could place usually entire dependence upon. Inventory that is quickly moving, of the department store type or a manufacturing plant, making consumers' goods, you would spend a lot more time on than you would where they are possibly producing big machines which it would take months to construct.

Q. And the scope of the examination would be adjusted to those differences?

A. Just to the factors themselves which are of main importance to the financial statement.

Q. Now, as to the nature of the system of internal check, how does that affect the scope of the examination?

A. Where we are satisfied that a system of internal check is good, and more importantly is functioning, we would not be inclined to do so much detail ourselves where we found that while the theory of the internal check might be good, that the application of it was poor, that you couldn't place much reliance on it, then you would go into it in more detail.

Q. In several places in the bulletin there is an indication that section 2 is particularly applicable to a small, moderate-sized business, whereas section 3 contains modifications for a large one. What would you say is the criterion by which you distinguish a large and small business for that purpose? Is it the value of the assets, the volume of the transactions, or what?

A. I would say all factors would be considered. You might have a business with large dollar sales representing few units. You might have a business with small dollar sales representing a larger number of unit transactions. You would have to take into consideration, it seems to me, the general over-all picture in the line of industry in which you were situated.

Q. In another place in the bulletin, I think page 9, it is indicated that the extent of the examination is to be determined by the accountant's knowledge of the individual situation. What is your feel-

ing as to the extent of such knowledge of the individual situation which an accountant should have before he completes his work? How much should he know about it?

A. He should know the safeguards that the business itself sets up. He should know from what he has seen the type of operations and how the company functions.

Q. Would you say that that should be a general knowledge or more or less a detailed knowledge, or what? How far must he go in that respect?

A. I would say general knowledge, specific with respect to particular industries, and in your familiarity with the kind of business the company is doing, you very customarily make comparisons with other businesses of the same type to see how they are going.

Q. Coming back to the particular concern that is being audited, how much should he know about the business, speaking of that as the individual situation?

A. You should have a pretty good idea of its policies, of its methods of buying and selling, and of producing, if it is manufacturing. You should have a very good idea as to the capabilities of its personnel and from your contact with the ability that they actually exercise in their work.

Q. What methods do you use, Mr. Mathieson, to develop your knowledge as to a client's accounting procedure and its system of internal check and control?

A. By observation and by tests. With the average type of client we have, there isn't always a specifically constructed system of internal control. We inquire as to how things are done, what departments or individuals are responsible for certain operations, and we make it a point to see that those operations are carried through as we are told.

Q. How do you find that out?

A. By inquiry all along the line and by observation.

Q. When you say all along the line, what have you in mind there?

A. I would frequently want to be sure that what the treasurer or comptroller thinks is being done is actually being done by inquiry of the person in the department responsible for doing it.

Q. Would you speak to people who were actually supposed to be doing these things?

A. That is correct; as the men, seniors and juniors are in the performance of their work, they would inquire into the people keeping these records and responsible for these so-called minor positions, as to just what their idea of their work is and what they do.

Q. Do you get any evidence from your examination of the documents as to how the system is working? For example, from an examination of purchase orders, would you see the approval initials and identify those?

A. Depending on the size of the business, where size would provide that copies of the purchase order would go to different departments, we would see that approvals of the purchasing department were set and we would see that proper steps had been taken to confirm or obtain authorizations from those from whom they are purchased and

that the prices indicated on the purchase order are correct and that those purchase orders and receiving slips properly back up the invoices which the company has.

Q. That is, if you were told that a particular person was supposed to initial all credit memoranda for returned sales, would you make any test to see that credit memoranda were in fact initialed by looking at the memoranda themselves?

A. Not necessarily. I would say that in reviewing or investigating return sales or allowances, we would be more inclined to discuss with the man who was supposed to have authority to approve them rather than depend on the document indicating that he has approved them.

Q. Do you make any sort of memorandum of what you found to be in the permanent file?

A. We don't carry a permanent file as such. We have a file which picks up in the course of time pertinent data with respect to charter, organizations, tax matters, test examinations, and other matters, but insofar as procedures in a client's office are concerned, we do not make that part of a permanent file. We insist that our men investigate each year to see what procedures are followed.

Q. If in your study of a system of internal check and control you discover certain weaknesses, would you say that those required that additional steps should be taken in the audit program?

A. Generally, yes; although again it would depend upon the purpose of the audit.

Q. Let us assume we have in mind an annual report to the stockholders somewhat along the lines—

A. An annual report to stockholders not active in the business—we would go further with the examination. In other cases where you have owner-management, or where you are trying to find results to substantiate bank loans or something of that kind, we might investigate somewhat further, but call these points that you just mentioned to the attention of management, suggesting that they be corrected.

Q. Supposing that you are making an audit for the purpose of certifying annual reports to the stockholders who are not active in the management of the business, and you found one of these weaknesses which, in your opinion, necessitated some additional procedure. Would you discuss that additional work with the company?

A. We would discuss it with the management before we proceeded with it, if it was anything significant requiring any appreciable increase in time.

Q. What would you do if the management refused to let you go ahead?

A. That is a rather hypothetical question. I don't recall it as ever having happened. I presume if it was important enough, we might draw out. In my experience we have been always able to reconcile opinions.

Q. Would you say that your verification of the system of internal check and control should result in a thorough knowledge on your part of the accounting system followed by the particular client, including a knowledge of the documents or papers which are supposed to support each step in the accounting procedure. For example, the documents which are supposed to be found in a voucher jacket.

A. Yes; with respect to that, answering your question. Otherwise I would say that we would expect to know about it, but it wouldn't be made a matter of record in any particular place as to what we know.

More generally, if it was something we didn't understand, we would put effort on that rather than following out the things that otherwise would be expected to be there.

Q. You wouldn't have in mind that you would examine all these documents each year, but simply would know what was supposed to be there?

A. Do you mean those pertaining to the year's operations, or those pertaining to evidences of ownership?

Q. The year's operations and the supporting evidence back of them.

A. Depending on the test that you are making of the operating records, you would make a pretty comprehensive examination for those periods. If you found them in order, you would be inclined to assume that the remaining part of the period was likewise in order.

Q. Let us say, then, am I correct in this, you say you would not examine all of the documents supporting all the transactions for a particular year. You would sample those?

A. You would sample those.

Q. But would you expect to be familiar with all the documents customarily used by the business in supporting these various transactions?

A. Yes.

Q. Do you feel that an examination of this sort should disclose fraud? I would like to have you refer in connection with that to page 10 of the bulletin, second full paragraph, the second sentence which reads as follows:

The procedure will not necessarily disclose defalcations nor every understatement of assets concealed in the records of operating transactions or by manipulation of the accounts

and to the periods that you take for sampling or testing, anything fraudulent in that time should be disclosed. It would not, of course, disclose anything in the period you didn't examine. Would you say that you should be satisfied as to the general accuracy and integrity of the records on the basis of your examination?

A. Yes; I would say we would and those periods we test that we select ourselves at random, if they are substantially right and we find no error, it is reasonable to assume the rest are likewise.

Q. I believe you indicated that the examination sample should include any fraud that was included in it.

A. The examination of the sample period is complete; it should disclose any fraud which came within that test.

Q. Now, you have indicated that you employed a sampling process. That does not conclusively verify the transactions not examined, I believe you said?

A. That is correct.

Q. Do you feel that nevertheless it is a sufficient means of examination for the purpose of giving an opinion as to the whole record?

A. Yes, I do. The experience in our own office and I think of the profession generally has borne that out over a period of years.

(Whereupon a short recess was taken.)

AFTER RECESS

B. CASH

(By Mr. WERTZ.) Mr. Mathieson, I would like to go now to the details of the audit program, taking cash first. Do you consider the program as to cash, which is outlined on pages 11 and 12 of the bulletin to be a maximum or minimum procedure and could you indicate any additional steps that you customarily do or any steps that you customarily omit?

A. It would be a minimum procedure. We customarily examine 3 or 4 months' checks and deposits rather than 1 month's.

Q. Do you add any other steps to the program?

A. Except in very large companies, in the months other than those we test we usually scrutinize cash records to see if any entries would look questionable or might indicate that we should go further with them. Other than that, I think we follow pretty much what the bulletin sets forth.

Q. Do you reconcile cash at any date other than the balance sheet date?

A. We attempt in the course of our work to do preliminary work prior to the end of the year. At those dates, which we do preliminary reconciliation, we confirm cash in the same manner we do at the end of the year.

Q. If you had done that would you again confirm cash and reconcile it to the balance sheet date?

A. We would; yes.

Q. On page 33 of the bulletin a reference is made to a reconciliation of bank accounts by employees independent of the cashier's department. How important do you consider that?

A. I consider it important, particularly with respect to financial businesses, members of the New York Stock Exchange, or banks where cash is the—cash or securities are the major commodities in use. With respect to average manufacturing plants, it is desirable but it isn't always possible.

Q. Would your opinion differ there as to reconciling small funds as compared to the larger general bank accounts?

A. Yes. I would say it would. Usually you find the small petty cash funds are well controlled by a system of internal check. With respect to branch funds and other offices in other cities, I think there should be a review or reconciliation, preferably at the home office rather than at the branch itself.

Q. Turning to item 8 on page 12, the last sentence of that item. Under what circumstances should a comparison of deposits be extended to include a check of the original deposit slips, or authenticated copies? Do you follow that practice?

A. We do not follow the practice. The circumstances in which we do it is where we have reason to believe there may be something questionable going on. As a matter of fact, it is not part of our routine to verify with the bank's copies of deposit slips. So-called authenticated copies of deposit slips which the client may have are just as apt to be fictitious as other records. In fact, we have so found them.

Q. That is, deposit slips a client may have?

A. Yes.

Q. Do you make any tests to determine whether receivables have been lapped by the cashier?

A. May I ask what you mean?

Q. What I mean, holding out a day's receipts and depositing them at a later time.

A. Yes; we make tests.

Q. What do you do there?

A. Well, you do it from several angles. First, from seeing that the deposits that are recorded in the cash book are deposited on the same day as indicated by the bank statements. You do it by test of postings from the receivable records themselves as to the dates the postings are entered.

If you had occasion to feel that maybe something was going on, you might go even further into different lines, under the circumstances.

Q. And those would be the comparisons?

A. One of them would be going to the bank and getting them from the bank.

Q. In the third line of item 8 on page 12 there is a reference to bona fide receipts. What do you understand is meant by that term? How do you establish a receipt as bona fide?

A. I am rather at a loss to understand just what they do mean by that. At the end of a period you might be looking for window dressing. That isn't so customary today as it used to be.

Q. Do you make any test to determine whether the receipts in the last week or so of the year are apparently in regular form? That is, are receipts from customers, not company checks, transfers and so forth?

A. We do, not only the last week but probably the last 2 weeks and the first 2 or 3 weeks of the new year to assure ourselves that there wasn't something put in affecting one period as against another.

Q. Is it customary, and proper, in your opinion to include in cash in banks amounts due from foreign banks or from private bankers?

A. Yes; providing they are at dollar rates.

Q. Is there any circumstance where it would vary?

A. Where currency is blocked, or where you have exchange restrictions.

Q. How do you determine, in fact, whether there are exchange restrictions?

A. Well, in the industry you are examining you know pretty well its custom, you know the basis of trading, a fairly general knowledge of what countries have blocked currencies. If we have any question we would be inclined to communicate with the foreign exchange bank, the Philadelphia National, to determine just what the situation was.

Q. How do you determine whether a depository is, in fact, a bank?

A. I have never had occasion to have the question raised whether it was or not. You could see, in the course of your examination, canceled checks, bank statements. If you had bank accounts in

outlying districts where it was customary to deposit funds from an agency or branch and those funds are currently being transferred to the major disbursing banks of the home office, I think you would accept they were banks. You get their confirmation on their letter-head, requested by yourself, and mailed yourself.

Q. You say you have never had any question as to this. Could you indicate why? Did you always know who the banks were dealing with?

A. No; we don't know the banks in outlying sections. I say we have never had the question arise to question the banks because in each instance the account has been real; the funds as a rule are moving. If they weren't moving, if we had a dormant account of any size, then possibly the question might be raised.

Q. Would you say, then, that you rely upon the apparent regularity with the dealings with the bank?

A. Generally, yes.

C. ACCOUNTS AND NOTES RECEIVABLE

Q. Now, turning to accounts and notes receivable. In several places, particularly items 3, 5, and 6, the pamphlet indicates the necessity of making inquiries as to particular matters. Can you describe, briefly, how and from what person you would get the information that is necessary there? About the sixth line of item 3:

Make such inquiries as may be deemed necessary.

That's on page 14.

A. With respect to paragraph 3, we would analyze the accounts receivable to determine the age of the outstanding balances for the purpose, first, of seeing that they were current accounts, that the balances were not comprised of old amounts that had been standing for some time while more current charges had been paid, also as an indication of what reserves might probably be required for bad debts.

Q. How far back would you go in determining the age of the balance?

A. We would take it back at least to the beginning of the year and if any substantial amount were prior to that, we would go into that. Ordinarily, there are just small amounts hanging over, usually as a result of claims being made. We discuss the condition of the accounts with the credit department as a rule. If any particular case came up we might even go to the sales department to see what they may have to say with respect to particular accounts.

Q. Now, in item 5, the beginning of the first sentence, and the beginning of the third sentence inquire into the practice, make inquiries as to customers' claims for reduction in prices. Where would you go to make those inquiries? What inquiries would you make?

A. With respect to the practice of trade discounts, ordinarily that is a matter of trade custom; the business of selling at list price less trade discounts.

Q. You would be familiar with that?

A. You pretty generally familiarize yourself with it on quotations being made. As far as the cash discounts—cash discounts greater than 2 percent, it would depend upon the type of industry.

Certain industries have a 5 percent cash discount with a very short term of payment, up to 10 days, possibly. Again, you should be familiar with the practices of that industry.

Q. Where would you go to inquire as to that?

A. If you had any question as to the fact after your investigation of the company records, I think you would find it either from the record of trade practices or by general inquiry. Very probably you would have clients in that same line of business whose records—whose practices you know.

Q. You mean other clients?

A. Other clients. As far as the claims for allowances and reductions in price with respect to material they ordinarily are something that would be originally presented through the credit department, the authorizations for allowances would come from them and you would discuss it with them. If you had further questions, particularly with regard to the effect of material, you find out from the production department what might be the cause of these allowances, if they were frequent.

Q. You mentioned that you would examine the composition of outstanding balances for the purpose of determining how old they were and whether a reserve was necessary. Would you make any other examination or would your examination be for any other purpose than that?

A. Your examination would be to see that the accounts represented sales of merchandise that are included in there rather than accounts with owners or employees for advances and that you remove from their accounts receivable, accounts that might arise from sales of capital assets or anything other than from sales in the customary conduct of the business itself.

If they were in there they should be segregated on the report.

Q. Do you expect in an examination of that purpose that the general conditions of accounts should be noted such as concentration of charges, unusual conditions as to credit allowances, write-offs?

A. I don't know that that is so much a factor if your client is in a seasonal business, particularly with respect to crops that ripen at certain periods, where you naturally expect more activity, or you have style goods that have periodic activity. You might be inclined to question large volume of transactions coming at other periods than that. I don't recall in my experience that that has ever come up.

Q. Now, at the top of page 15, there is a sentence in regard to confirming accounts receivable which reads as follows:

While such confirmation is frequently considered unnecessary in the case of companies having an adequate system of internal check, it is one of the most effective means of disclosing irregularities.

Is it your understanding that this sentence implies that receivables ordinarily should be confirmed?

A. No; it is not. It is admittedly the best way to verify it but up to the present time the clients haven't yet, shall I say, been sufficiently educated to always agree that it is necessary and the expense incidental to doing it has also been a factor of stopping us from doing it.

Q. What is your practice as to that? Do you generally confirm receivables or not?

A. We like to confirm receivables wherever we can. If we can't, we frequently make test confirmations of certain accounts where balances might be large or where there might be numerous claims arising, or the account has been subject to controversy.

Q. Do I understand that you generally make either a test confirmation or full confirmation?

A. No. In very many cases we don't confirm at all. If the accounts appear in good order, if there is nothing to excite suspicion, and the cash is collected and deposited in banks in due course and the volume of business is going through business channels, we would not insist upon complete confirmation or necessarily on test confirmation.

Q. How do you feel the credit and adjustment record of a particular account affects the desirability of confirming the receivables?

A. If there is a lot of activity from the standpoint of claims on the part of the customers, if there have been numerous allowances, in your investigation of the accounts you probably request permission to confirm them, or you might, for the sake of a client, if nothing else, to determine what the balance actually is, possibly have a customer commit himself to what the claim really is.

Q. How about the question of collections?

A. If collections have been held back, if the account is old, or if the balances have been piling up, apparently out of proportion to what that customer's account should be, we frequently confirm it in order to get true facts concerning the case and be sure that a charge is not being put in there that doesn't belong there.

Q. What weight do you give the collection of the accounts since the balance sheet date but prior to the audit?

A. If the account has been paid, and if there is nothing to indicate in the payment that there is anything unusual, if regular terms of sale are being met, we consider that it is fairly good verification of the accounts. We frequently, in our practice, confirm accounts at the end of January or possibly at the end of February that still have some part of the December 31 balance, as a means of test check.

Q. Would you trace the cash payments since the close of the year and prior to the audit into the cash account, if you are going to do that?

A. Not in detail; no.

Q. Would you make some general examination?

A. Well, if your investigation of cash and the records of the company indicated to the proper entry, receipt entry, and deposit of funds, you would assume that the period succeeding December 31 had been indicated that way. Ordinarily, January, assuming a year-end investigation, would be the month used for a good many of your tests.

Q. What is your feeling as to the relative value of confirming receivables? That is, a direct positive confirmation of as many as possible as compared to a sampling process and the final method of negative confirmation?

A. Direct confirmation of all would be preferable. A test that is made in such a way that you would get a good cross section would be better than nothing. So far as the negative confirmation is concerned, personally I have never felt it worth very much.

Q. At page 8 and at page 34 under "Accounts Receivable," reference is made to safeguards surrounding the handling of incoming mail, remittances, and to the mailing of monthly statements to customers. In this connection, what inquiries or tests would you make? What would you do to assure yourself that the procedures would actually—that the statements were actually mailed to customers?

A. I don't know that we have ever made any tests to see that the statements have been mailed to customers periodically by the client's own force. Where we have confirmed, we of course mail those statements ourselves in our own envelopes so that any wrong address would be returned to us and not to the client's office.

Where we have not been permitted to confirm we have, in some instances, mailed the customer's statements ourselves in our audit program. Sometimes in our own envelopes, sometimes in their envelopes, not for a confirmation but to see that the mail was going out.

Q. Do you feel that the actual mailing of statements to customers sheds any light on the authenticity of the accounts and so forth?

A. Do you mean by the accountant or by the client?

Q. By the client. Under your supervision, that is, assuming you actually know they are mailed.

A. I do not know how we know they are mailed. In your bigger organizations there are usually centralized mailing departments and there frequently are so-called mail clerks who rotate through the offices of the plant collecting mail and distributing mail to departments and to go outside. I do not know of any instances where there has been a check-up to see that everything that should be mailed was mailed.

Q. I thought you said a moment ago that when you were in the client's office at some date you would see that the statements actually were mailed.

A. I say we have in our practice at times, where we have not been permitted to confirm the accounts, taken their statements and mailed them ourselves, but never have we checked to see that the client mailed them.

Q. Do you feel that is some assurance of the authenticity of the accounts?

A. Yes; I should say it was. It is better than nothing.

Q. On page 34, again. What kind of an examination do you understand is meant by the expression "Relatively limited test" in respect to the individual customer's account? That is on page 34, fourth and fifth lines.

A. I don't know exactly what might be meant by that. The examination of customer's accounts, ledger sheets, I have explained what review we would give them insofar as aging and classification of balances and seeing that the balances were current, questioning old balances and questioning set up of credit allowances—or rather reserve allowances. What is meant by this bulletin—

Q. In the case of a large company, do you examine every account receivable?

A. We verify the trial balances in all receivable ledgers as part of our practice; yes. We do not depend upon a test check of a few ledgers out of a total.