

I think we might make some inquiries, of course, about consigned goods. We would make inquiries, of course, whether some of the goods there have been billed.

As I have indicated, I have something of an obsession about that because I had a good bit of experience from the inside. As to that, I think of the thing that in our accounting jargon, we refer to as the cut-off. I think that would be—have to be investigated very carefully so that I should suppose that there would be no doubt in my mind that because the seniors have all been told to do it, that the senior would take the sales of the last week or 2 weeks, even, and would compare them with the shipping records to see that all the goods that were billed were shipped, or else were set aside as being property belonging to others than the company, and, similarly, about goods received.

I think the same arrangement about incoming goods and the invoices therefor would need to be checked over for a considerable period, week or two, antedating the date of the balance sheet and succeeding the date of the balance sheet to see whether there was anything in there to suggest that the cut-off had not been done properly.

Q. Would you attempt to trace any inventory, physical, on hand, if it were identifiable?

A. Yes. It has been our practice always to do enough work on inventory so that we do not feel any need of making any exception in our report.

Now, that does not at all mean that we are willing to guarantee or to warrant that all of the goods are there but it means to say that we feel a responsibility for expressing an opinion on the financial condition of the company and this being the question that we are speaking of now in which the inventory will be an important element, or factor, in the determination of the financial condition, we will always want to do enough examination of the goods themselves to satisfy ourselves that in general they have been in existence and that they have been worth—they have been in quantity and in value about what they are represented as being.

Q. Now, going back for a moment to the question of a cut-off. You stated that you had examined a number of records in that connection. What records would you examine; what documents and what would you be looking for on them?

A. Well, it would depend, wouldn't it, on what you found there? Because, of course, there will be varying forms of documents and nobody in the world could start right out and tell the senior, "Now, what you will find is that," because unless you have been there and know just how they happen to do this thing, you do not know what he will find, but there will be some sort of shipping records and that will be his task to determine with what ingenuity and mental alertness and cleverness he can, how these records that they have can be adapted to the determining for him whether this cut-off has been done adequately.

I think that you have made reference before to the matter of fixing the date. If it should happen that the records were such in which it might be difficult to satisfy one's self as to date of ship-

ment, I could easily imagine that I would say "Well, now, let's see the bill of lading, outgoing, or the waybill, incoming." That would, or should, establish the date and for that purpose, for the purpose of fixing the date, I think we might go to those subordinate and more or less distant documents.

Q. In verifying the accuracy of footings and extensions in the client's inventory schedules, do you employ comptometer operators in your firm?

A. Well, we have not. Not that we have any objection at all to it, but it never seemed to us as though the confusion that would be involved by bringing somebody in who was not of our own organization was—that being its disadvantage, could be compensated by any advantage that we would get from, let's say, lowering of cost by paying less per diem for the services of such an operator. And I have a good deal of feeling, myself, that it is a pretty fair thing for a junior accountant to learn to add rapidly and, of course, we tell them that they need not bother to add cents, add the dollars and carry over what reasonably ought to be right from the cents.

I think also it is a good thing for the junior accountant to learn to do mental arithmetic with a fair degree of rapidity.

My feeling is, really, that we do not in any case impose any more cost on our work by having the juniors do these verifications by pencil and brain than would be the case if we were to bring in comptometer operators and I think we have a very much more satisfactory control of what is done. Not that I have any objection to the use of comptometer operators.

If there were a tremendous amount of work, such as would make it clearly apparent that something would have to be done in that way, why I would do it.

Q. Now, if the procedure outlined in the bulletin as to inventories has been satisfactorily completed, I think you stated that it was not your practice to include in such cases any qualification as to your responsibilities for the quality, quantity, and condition. Is that correct?

A. Yes; that is the fact. That has always been our practice. We have had, perhaps, something of an obsession about that. In my whole public accounting experience, myself and my partners have never been willing to do that. That is, we have always felt that we were there to certify to the financial condition of the company and that we must find a way in which to give ourselves a satisfactory opinion as to whether the financial condition was as stated and we have kept on at the job until we could do that.

Q. If you find included in the statements, or in the accountant's report an indication that the auditor has relied upon responsible officials for information as to the quantity, quality, and condition of inventory, do you feel that this avoids the necessity of making the tests and inquiries that are outlined in the last sentence of item 3 under "Inventories"?

A. Well, I can only answer from our experience. We have never felt that—we have always felt we would do it in any event.

Q. What type of tests and inquiries do you feel that sentence contemplates, Mr. Horne?

A. Well, that item 3, page 12?

Q. That reads as follows:

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

On page 18, that is.

A. This is sufficiently foggy so that I didn't read that immediately. Well, I think the preliminary sentences of that paragraph express the thing pretty well:

The duties and responsibilities of the accountant in the case of quantities, quality, and condition of stock vary with the circumstances, but he must rely, principally for information as to quantities, quality, and condition upon responsible officers and employees of the company.

In the case of a business which does not call for technical knowledge and presents no substantial difficulties, the accountant, by special arrangements with his client, may be justified in assuming a greater degree of responsibility than in cases where expert knowledge is essential.

I think I would accord with that entirely.

Then,

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

And, of course, the tests that I would think we should make as to quantities would be to see if there were some substantial items in the inventory that we certainly felt we ought to look into. We would make verification by working back from the inventory, as of the particular day when our man would go out.

He would say, "Well, there are now——" let's say, "so many cases of those goods on hand. Do you agree with that?" "Yes; there are so many cases here."

Then go back to the records and find that there have been records of sales of so many cases in the interval between that date and the inventory date and that there have been purchases of so many cases and the arithmetic of that would indicate that there had been that many cases at the inventory date, approximately. Perhaps, since I am talking of cases that ought to be precisely, but that, of course, wouldn't apply with such extreme precision with respect to many other things. But I think tests of that sort are the things that I can honestly say we always make.

Q. Would you make, also, tests of the records in case there were perpetual inventory records, or tests of physical inventory records?

A. Well, where there are perpetual inventory records, of course, the accountant's path is very much simplified. If there were perpetual inventory records, one might go out and look at what was there at the warehouse and come back to the perpetual inventory records. It should be the same. If not, why not?

Q. Do you review the method which the client has followed in taking inventory?

A. Yes, we always ask them quite definitely and clearly what are their instructions and we try to see that the inventory sheets and the general appearance of the inventory conform with what they have said. If it doesn't, why, of course, we have to go and look further.

Q. Could you indicate, briefly, what you feel to be some of the more important points in a satisfactory method of taking inventory?

A. Well, the method would differ with every sort of business, but if we think of what I suppose usually comes to mind, perhaps something in the line of hardware or machinery, or something of that sort, why I would suppose that the organization would require that men who were familiar with the product, whatever it might be, would go around to the various bins, or receptacles, or places where the material is kept and put tags on them which would contain a description which would be accurate, maybe by some sort of symbolization, and would then make a count and indicate how many items of that article were there.

A good arrangement is to have those tags with a perforation on them so that they are made in duplicate and they are all consecutively numbered and then another crew, perhaps clerical crew, shall go around and tear off the duplicate tags, make the double check, so to speak, on the count, that there were that many there and then the tags might all be assembled, might all be checked to see that all were there by consecutive numbering, and there were none missing, and after that was done they would very properly be sorted into groups or classifications by description or by some device of symbolization, and then tabulated on inventory sheets, and those sheets then checked back.

Q. How do you go about establishing that the method of inventory taking intended to be followed actually was followed, that these points had been observed?

A. Well, usually those tags will have been kept until the auditor is finished. I am thinking of a case in which we, I think of this very definitely myself, in which we observed the taking of the entire inventory and participated with the company in laying out just this sort of program. So we saw it all.

Q. Do you make any sort of inquiries?

A. Make inquiries of all of the folks that should have done it.

Q. When you say all of the folks, who have done it, what do you mean there?

A. I don't mean to convey by that I would go to every one of these workmen, let's say, who identified the product, no; make inquiry of the man, let's say, who was in charge and—well, possibly in cases go to the individual man who tagged the material. I can easily see that this might be so because it might very often, and I can easily say it would very often happen that the clerical man might not be altogether familiar with the kind of description, so you might have to go to one of these men in the plant and say, "Well, now, where is this particular thing," indicated by a symbol, and what does it look like and what kind of a thing is it, and he will take you there and show you.

Q. If you feel the client's method of taking inventory is unsatisfactory, do you take any particular position in that case?

A. Well, we would, of course. There wouldn't be any question about that.

Q. What would you do?

A. It might require an entire new inventory. We might just decline to issue any statements at that time. If the plant had to be

shut down and a whole new inventory taken over again, you would probably put it off until the end of a month or something of that sort and do it over again.

Those are extreme possibilities. I cannot think of having done precisely that at any time. The particular case that I had in mind was a case where an inventory had to be taken at an interim time and it was because of that that we did direct and observe and in a sense supervise the inventory. Even though when I say supervise, I want still to insist that the company took the inventory; we watched them.

Mr. WERTZ. I wonder if we might recess for lunch at this time?

The EXAMINER. We will recess until 2 o'clock.

(Whereupon an adjournment was taken until 2 o'clock p. m. of the same day.)

AFTERNOON SESSION

Q. (By Mr. WERTZ.) Mr. Horne, we were discussing before recess the question of inventory. Now, in appraising the accuracy and integrity of the inventory records of the company, particularly in regard to quantities, quality, and condition, do you ascertain and give weight to the nature of the shipping records, the receiving records, and the stockkeeping records, and the methods by which they are kept?

A. Yes; the answer to that would have to be in the affirmative, although, of course, we would speak of cases in which there might not be any formal perpetual inventory records which I suppose is what is meant by stockkeeping here, and in that connection, of course, if there was none we couldn't depend upon it. But, of course, in respect of shipping and receiving records in establishing the accuracy of what I referred to this morning as the cut-off, that would be just about necessary.

Q. What significance has the independence of the personnel engaged accounting-wise in those operations?

A. Of course, the same considerations that would be applicable to the handling of accounts receivable and cash by separate persons should apply there. The more definitely you can have those different functions separated, the more assuredly you can feel that there are no defalcations of materials, if it might be expressed that way.

And, of course, the matter of properly caring for the material in stock may be said to be quite as important as the caring for the cash. In fact, sometimes the material is worth a lot more than a like weight of cash.

Q. Am I correct in believing that you stated earlier that you felt the auditor should be generally familiar with the nature of the product manufactured or dealt in by the company?

A. Generally familiar, yes; I think I said that, and I certainly wouldn't want to convey the idea that I thought he ought to be an expert, but there ought to be a general familiarity.

Q. Is it the practice of your firm, Mr. Horne, to make spot tests of the inventory by actual count or inspection?

A. Yes; I said that this morning and I will say it again in the specific case, the matter of observing that the material is there and in general the quantity is there, is the thing that we always want to assure ourselves of.

Q. Is it your practice to make any over-all tests as to the reasonableness of the inventory quantities by comparison, for example, with warehouse capacities, by comparing the insurance coverage, by examining the average production and consumption record of the company?

A. Of course, we do make those over-all tests. Specifically as to warehouse capacities, I have never had any occasion at all to think of doing that. That is a thing which might be thought of if there were huge quantities of materials on hand.

I don't remember that I ever encountered any such experience and I feel sure I never did.

Of course, the relation of the average consumption and purchase and the amount of production by the individual company would be a thing that would be very desirable to examine and would be examined in determining whether or not there was a likelihood that we had a great deal of obsolete or stale material on hand and to assure ourselves, let us say, negatively, why we would want to see that the amount of inventory of a particular material on hand was substantially less than would be produced in, let us say, an entire year's operation or would be purchased within an entire year, so that I think we cover that thing quite accurately.

You spoke of insurance coverage. I have a little peculiarity myself about that, I think. It seems to me that accountants are not called on to intervene in respect of the amount of insurance carried by a company. It seems to me that that is its affair. That is an operating, a managerial matter. That is, I cannot conceive that there is anything wrong at all even as a matter of business judgment in not insuring some things. Plenty of cases there are where operating officials may very well decide that the risk was not nearly as great as the insurance premium purported to make it, but the matter of seeing that there was insurance coverage wouldn't be a thing that I feel would be controlling in the slightest degree on whether or not there was inventory on hand, and I think that about tax payments that is a little more remote even than insurance coverage, because it is almost inevitably the wish of every treasurer to cut down the value of the property on which he has to pay a personal property tax.

Q. Would you make any inquiry or investigation as to whether there is insurance?

A. Why, we would do that inevitably as a part of the auditing routine when we came to determine whether there was or was not a deferred asset in respect of the unexpired insurance.

Q. Now, turning to some of those tests we were mentioning a moment ago: Do you employ the gross profits test at all?

A. Yes.

Q. And if so, for what purpose?

A. To determine really whether there seems to be a general consistency and reasonable relationship between the amount of inventory on hand and the amount produced, because if we seem to see a disproportionately or an unusually large gross profit, there may be a pretty fair suspicion either that the present inventory is substantially over-valued or incorrectly taken as to quantities, or that the beginning inventory may have been under-valued.

It is part of our guide in determining whether or not there are any weak spots in the situation that we would like to see and further explore.

Q. Likewise, if the gross profit were unusually small?

A. Of course, it might indicate errors in the reverse direction of those I indicated before.

Q. Should that gross profit test be applied to the aggregate figures, or on a departmental basis?

A. I think the answer is, of course, it ought to be applied on a departmentalized basis if it is possible reasonably to get that data available. We try always to do that and there have been times when that has been really very useful to us. I can think of two cases which come to my mind very quickly, one in which a proposed purchase of a company was not consummated because that breaking down of the inventory and the purchases and sales indicated some conditions that were not at all satisfactory to the prospective purchaser so that I would say that in every case in which it is at all practical that should be done, and on the other hand I recognize that very often there is a lack of records that will permit that breaking down.

Q. Now, as to merchandise which is not held in the company's own control, but in outside warehouses, what procedures do you customarily rely upon to verify the quantity of such merchandise?

A. Well, if it were a regular warehouse and the goods had been there for some considerable time, I think that we would always ask that the warehouseman confirm to us, that is, we would ask our client to ask the warehouseman to confirm to us that there was such material by quantity and description there.

I think it is a fair thing to say that if it had just come in, let us say, if there had been an importation in the last previous week and it had been taken out of the ship and put in a bonded warehouse and there was no record of any withdrawals, I think we might conceivably do nothing about that. Yet I would think that if there was any doubt, that the thing to do would be to get a confirmation from the warehouseman.

Q. Would your procedure be any different if the goods were held by the vendor under his control?

A. I think if the goods were held by a vendor and were not in possession at all in any way of the company being examined and it had not any warehouse receipts or any advices of that sort, I think it would be almost inevitable that we would ask for a confirmation from said vendor.

Q. Would you get any evidence as to the financial responsibility of the vendor in such cases?

A. I think I would not, although I can conceive that there might be cases in which circumstances might make one wonder whether there really was any such vendor. There might be such circumstances. I have never run across any such and I just don't know that I can well imagine circumstances in which that might happen.

Q. Or where you had some doubt as to financial ability as to the vendor, would you do the same thing? Not that there wasn't any such vendor, but you weren't aware whether he could make good on his contract.

A. Well, of course, I have never had any such circumstance at any time and I suppose you mean where the goods have been paid for and so our client will have parted with the assets representing the purchase price and had not yet received the goods?

Q. Correct.

A. Well, I think I would not take any steps. I think that I would consider it to be a fair presumption that before they purchased the goods, they had at least assured themselves that the goods would be deliverable, and then going another step, that before they paid for them they would have made definitely sure they could be delivered to them.

Q. Would the procedures you would follow disclose whether or not the vendor had misappropriated the goods?

A. I don't think you could get anything at all on that without going and examining the vendor on that. If you did receive a confirmation from the vendor that he owed the company that much goods, you just wouldn't know whether he had them, or whether he could deliver or anything else without going and examining him, unless you are thinking of making a separate investigation on behalf of the client through credit agencies, etc., which certainly I think we would not do.

Q. Do you make any other test as to quality, quantity, and condition of inventory than we have mentioned.

A. I can't think of anything that we haven't mentioned. It seems to me that in general we have spoken of about all the kind of things that we can do to determine that the goods were there.

I think we would make inquiry about condition. I think if we saw goods obviously in bad condition, I think we would know it.

If it wasn't obviously in bad condition, we wouldn't know it, and with respect to quality, I think always we would just have to say that we were not experts to pass on quality.

Q. Looking to the future, Mr. Horne, what procedures do you think auditors should use in establishing the quality, quantity, and condition of inventory?

A. I can't truly, Mr. Werntz, think of anything more that we should do unless we were to agree that we would take very much more of financial responsibility than I think we are called on now to take in respect of inventory.

I think that we have been feeling that we could rely on the attitude that was expressed in that New York State Society of Certified Public Accountant's resolution in respect of inventories, that when we make a statement or when we sign a report appended to a statement of financial condition in which we make no exception about inventories, we mean simply that in our capacity as accountants we have formed an opinion that the financial statement correctly and fairly represents the financial condition of the company and to the extent that the inventories are a necessary element in determining that, we believe, it is our opinion, that the inventories have been approximately correctly stated, but that is altogether aside from any assertion that we know that the quantity is correct, that we profess any skill at all with respect to quality, and that we have very much of an idea about condition.

Q. Would you favor the participation of the auditor in the work of taking the inventory; that is, by laying out the program and supervising or being present, observing taking of inventory?

A. Yes, I would, but I just wouldn't want too many of our clients to want that done at the end of the calendar year. If we could bring about the general adoption of the natural business year so that there would be a distribution of the work throughout the year, I do believe that we could render our clients a real assistance there.

In fact, I have this thing come to my mind immediately, this particular proceeding in which we are now involved has so disturbed some of our clients that one of them made a rather peremptory demand that we have two men appear there and observe the taking of the inventory, and we did that.

There are others who, of course, have changed their mind a good bit, who thought that, "Well, the accountants can't do very much about inventory, anyway, and we will just tolerate what they do," but being a little bit discouraging about what they do. They have withdrawn from that attitude pretty thoroughly and we have a pretty clear slate and we can go ahead and do what we choose. So that I think the answer would be that it would be a good thing.

Q. Would you necessarily have to observe the taking of the physical inventory as of the balance sheet date?

A. Well, if the inventory were not a thing that was auxiliary to perpetual inventories, I think that is so. I think in my testimony this morning I referred to a case in which it was desired to ascertain (I didn't say this in detail) not only the profits for the year last ended, but the profits for the 9 or 10 months just presently ended, and the financiers felt they must know that before they could go into that bit of financing, and in that case we said there is only one way to do, close down the plant, take another inventory there; in respect of that case I am speaking of we did work with the company, plan for the inventory, observe the taking, assisted in the count and did all that sort of thing, but that was all off the regular fiscal closing date.

Q. If you had satisfactory perpetual inventory records you could make tests as to the physical quantity at various times throughout the year, could you not?

A. And I think that that is an ideal condition. I think that where perpetual inventories are kept and are well kept, the proper procedure for the company itself is to take what I have come to speak of as a rotary inventory, that is, if we were to divide it up into 12 parts in some way, take an inventory of one of such parts every month and in that case that could be adapted very nicely to any auditor's program of laying out his work, of course, with the necessary prerequisites that the auditors had been engaged early enough in the year so as to be free to go in and do that.

Q. You stated in answer to various of these questions that you do make some sort of physical tests of inventory by spot checking, etc.

A. Yes.

Q. Could you indicate whether that adds materially to the expense of the audit?

A. Well, I wouldn't think that it added materially because I don't believe we would do any less. It is just that much. That is what it costs.

If we were to omit those, if we were just to avoid doing anything at all on the inventory, time might be conserved—

Q. That is physically.

A. Physically, yes, I mean physically, I believe that that might mean a fairly substantial reduction because the time of the men going out and, let us say, snooping around things which up until then they have been unfamiliar with, that does work out to a fair amount of time.

Q. Would you put that in terms of a percentage of your aggregate audit fee?

A. It would be the wildest kind of a guess and it would seem to me if I were to say 10 percent, that might hit it off, that is to say, if we were to agree that we simply would not do anything at all out in the warehouse, we might whittle down 10 percent, but if we weren't going to do anything at all about the fact of establishing whether the merchandise was there, we would fuss more on the figures and that would take up more time in another direction.

Q. One other thing in this problem, in our forms we require that the basis of determining the amount of the inventory ought to be stated in the financial statement. You have already indicated that there are possible differences in meaning of the term "market." Are there also differences in the meanings of the term "cost"?

A. Just as many differences.

Q. Would the application of a different method of costing the product result in significant differences in the balance sheet amounts?

A. I would not expect it to do that in any case where the procedure had been consistent as to inventory as to the beginning and ending of the year.

Q. I had in mind that, to illustrate, would the amount shown on the balance sheet under a first in-first out be apt to be significantly different from the amount on an average or last in-first out cost method?

A. The amount as to any particular inventory might be substantially different, but in its effect on the income statement, and I thought I understood you to say that—

Q. First on the balance sheet.

A. On the balance sheet it might make a substantial difference, but I would not think it would make very much difference with respect to the income statement if the inventory were taken on the same basis at the beginning and end of the year.

Q. Would the use of the two different methods result possibly in an allocation of the profits to different periods, for example, if you used first in-first out on a rising market as contrasted with last in-first out.

A. Yes; that is one of the arguments for using the last in-first out, to smooth out your violent fluctuations.

Q. If that is done, do you feel that the term cost or market is sufficiently explanatory or should there be a further indication of what is meant by cost and what is meant by market?

A. Of course, I cannot go back on our reports that the inventory committee made, that in the case of the oil companies, when they adopted the last in-first out, that they should say so on the balance sheet. I think that that is so, but if one were to say that all of the possible variances of cost or market should be all spelled out in a classification and that cost, meaning form No. 3, and market, meaning form No. 4, should be used, I just don't think it would help the investors any. I doubt if it would help the directors. I think you can get to the point where you get such a multiplicity of financial detail that the reader is rather stunned and gets no clear comprehensible picture from the statement.

Q. Is it possible for a given company to use two, or many, bases of cost with regard to its inventory, that is, different products being costed on a different basis?

A. I think it is possible.

Q. In which case, to go further, you would have to indicate the proportions?

A. Yes; with respect to each cost. That is possible. While nothing comes to my mind at the moment, I would not say that I have not seen that arrangement. The Treasury Department does not look upon it with favor, but practically I think it is done.

E. OTHER BALANCE SHEET ITEMS

Q. Now, turning to some of the other items on the balance sheet and referring here to item 4 on page 21, how do you determine that amounts capitalized as additions to plant represent real additions or improvements? What procedures do you follow? Do you inspect the plant or the additions?

A. My feeling is that very few of us, and I think I have had a wee bit of engineering training, are competent to say that plant additions were definitely improvements.

I think as to that I would always rely on what the engineering or architectural advisers of the company had to say. Of course, perhaps I have indicated that I have done a good deal of work for public utility companies. They have got the matter of plant construction items quite thoroughly formalized and they usually have authorizations for such projects.

Now, those authorizations are almost invariably put through quite a careful bit of scrutiny, usually come on up to the directors and especially to an executive committee if there is such, and by the time that authorization gets approved, one can feel reasonably sure that the work is being done thereunder as described in the authorization.

Q. Now, as to this: Do you make any test to determine that assets which have been fully depreciated are no longer in use; in other words, that they haven't had a condition of over-depreciation?

A. Now, of course, that sounds to me like a tax question because if there is any intimation that simply because any asset has been completely provided for by depreciation, if there is any such suggestion, in such case, that the asset should be removed from the plant account on the books, I just do not agree. I believe every asset which is in existence and in use ought to be represented in the plant account on the books even though it is 100 percent depreciated.

In fact, there is one case where we classify (I don't remember whether that gets into the ultimate statement that goes out), but we do classify some among the assets as those which are fully depreciated (they are in use every day), and those which are not fully depreciated, so that I wouldn't think for a moment of suggesting that assets which have had depreciation fully provided therefor, I wouldn't think that such assets should be excluded from the assets accounts.

Q. Do you make any tests as to the converse situation, namely, assets which have been removed from use or abandoned but not taken out of the accounts?

A. We make very pointed inquiry about that, and on occasion, although not invariably, we will ask somebody who knows some official who is in charge of the plant construction, the superintendent of the plant or something of that sort, to give us a statement that no obsolete or abandoned property is included in the plant accounts.

I think that that is not a universal practice on our part but it has been done and fairly frequently, but we do always make inquiries and you do see by the operation of the plant account that there are certain withdrawals from the plant account. If not, why the question is always: Why not? And of course we may get an answer as to why not, but it will at least smoke out some comment with respect to obsolete property if there is such. I think really we understand pretty clearly whether or not property that is abandoned and is of no further use, we understand pretty clearly whether it is or is not excluded from the property account.

Q. Now, turning to insurance, what procedure do you follow to determine the amount of insurance charges properly allocable to a particular year?

A. That is a regular routine procedure as I think it is of all accounting organizations. We examine the insurance policies and I would have a schedule prepared for us or we would prepare one ourselves and then by computation determine that the proportional amount is projected forward into the future period.

Q. Do you utilize the information gained from that examination in any other way than for this purpose?

A. I think I talked a bit about insurance this morning. I am not at all convinced that accountants ought to intervene in respect to that much of the business policy as comprehends insurance. I know other people have other thoughts about that, but my own feeling is that I would just leave the management alone in respect to that. If they want to insure, that is their affair, and if they do not, that also is their affair.

Q. On page 24, in item 2-C, there is a suggestion that a test examination be made of creditors' monthly statements covering large balances. What do you consider an adequate test and what sort of test do you make in that connection?

A. The answer that comes to my mind in respect to that is that many years ago that was one of our standard procedures: Examine creditors' monthly statements. I think that that has fallen into disuse largely. I suspect because the running account payable has also fallen into disuse. Where a voucher register is used and the accounts payable are represented by a series of vouchers, there is a considerable amount of difficulty in just practically matching up these statements

from creditors with the vouchers and so our procedure has been varied, perhaps quite definitely, I think I might almost say. If there are creditors' statements, see them and see if you can find out anything about "liabilities not on books" which is the phrase that we use in our organization, but the procedure that we insist shall be followed is that the vouchers for the next month be examined and leafed through to see if there are any invoices that are applicable to the period prior to the date of the balance sheet and also a requirement that if we go in very close after the end of the year, for example, that all of the invoices in the office that have not yet been vouchered be rounded up and put through the same process of examination because with the coming of the voucher system of handling accounts payable, the statement from the creditor has got to be a good deal of a nuisance and there are other ways of getting the thing more quickly and surely.

Q. On page 8 in the last paragraph, there is a line reading:

Approval and entry of vouchers will be made by others than the disbursing officer.

Would you indicate what to your mind would be the effect of such a requirement?

A. Of course, that would be part of this device of separation of duties which come within the scope of the internal control scheme. I think that it is just sound common sense, that if there is sufficient personnel there shall be more than one man who shall decide whether an amount shall be paid and so, of course, the approval of a voucher for payment ought to be based on the work that one group of folks will have done, maybe there will be different people there, in seeing that the goods have been received, that they are in accordance with the purchasing agent's order and that the price is correct and he will probably approve that, and that somebody has gone over the extensions and they are correct and the footings are correct and that generally it comes within the scope of the permitted disbursements and so I would think that a treasurer or an assistant treasurer would be the one who would approve the vouchers and then a separate person, the cashier, would be the one who would actually prepare the check and see that it got issued.

Q. Would you feel that the separation of these two duties were one of the more or less important features of an internal check?

A. I think it is one of the most important. I think that that would be one of the types of separation, that I would suggest should first be attended to.

Q. Now, as to taxes, Mr. Horne, do you expect an auditing staff would be generally familiar with all types of taxes that would impinge on a particular business?

A. Generally I think we should and in fact in our organization we have something of a reputation as tax representatives so that it just percolates down through the whole organization that we have a feeling that they know about them and they want that they shall know. And in respect to domestic taxes, I am limiting it to domestic taxes, I think that, generally speaking, our men do recognize and understand the types of taxation.

Q. As to foreign taxes?

A. Well, as to foreign taxes we just have no special knowledge other than the general knowledge that every man that is interested

in business ought to have. I think we do not know about foreign taxes.

Q. Do you make special inquiry as to taxes that are applicable to a particular case?

A. Yes. There is a case that I am thinking of in which we had to get advice from a foreign country as to a foreign branch over there. Now, as to that, we cannot get any very specific advice, because the managers of the business in the United States here say that they are quite ignorant of the tax situation in their own native country.

In respect to that particular company, we made a complete disclaimer as to any auditing whatever of the foreign branch and stated that, "We have accepted the statements of the foreign branch as submitted."

And I think we have gone on to say, "And as translated for us by the representatives of the company."

Q. Now—

A. (Continuing.) However, we can—excuse me. We can translate the foreign currency into American currency at the published rates of exchange and so, of course, the matter of translation has to do really only with the textual representations.

Q. Now, as to contingent liabilities, Mr. Horne, what procedures do you follow to determine their existence and amount and what responsibility do you feel the accountant assumes in that connection?

A. Well, I think the accountant has forced on him a great deal of responsibility about contingent liability, I think rather unjustly and some of it rather foolishly, but nevertheless we have to think about them and I think a great deal more than the contingency justifies.

With respect to that, if there are notes receivable that are received and discounted at the bank, of course there always is a potential contingent liability and we always make inquiry about that or ask our clients to make inquiry of the bank and ask the bank to advise us, all of the banks, with which they have been doing business so that there we get a very nice and definite confirmation or statement, maybe in a negative sense, from the bank with respect to contingent liability on notes discounted.

If properties have been sold and mortgages thereon may have been issued (in respect of the bond part of the mortgage obligation) the properties have been sold and the mortgage running to others without there definitely being any discharge of the bond, why we make inquiry about that.

If there are any guaranties—well, we ask if there are any guaranties or if there are any endorsements of paper, and sometimes assignments of leases are things that seem appropriate to inquire about.

I can recall myself, going over the whole gamut of imagination to determine whether there were contingent liabilities and if so what they amounted to and then deciding in my own mind whether I would say a word about them in connection with the balance sheet.

Q. Do you discuss the matter with the company counsel, as for example the contingent—

A. As to litigation, you mean?

Q. Yes.

A. Yes. There have been very many cases in which obviously there was a lot of contentious litigation in which the outcome would be

altogether beyond the possibility of any layman to make any kind of a guess. In that case we asked the client, or asked his counsel to give us his opinion as to what the outcome of the litigation might be and in some cases where they simply have no judgment on that, why, we have said so in the report that we have made.

Q. Do you examine contracts that may be within the company's files?

A. Yes.

Q. For that purpose?

A. Yes. We examine all important contracts that would come to our attention, either through the operation of auditing the company's records or as a result of having been told about them in the course of conversation.

Now, of course, that doesn't mean that we examine all contracts, by any means. There would be very many purchase contracts of a regular routine nature in which goods were to be bought at the current market and in that case I think it is safe to say we wouldn't think of looking at them.

At times when there are distinct variations in commodity costs, why contracts that involve commitments or material purchases have to be considered very carefully and I remember very vividly back along in 1921 or 1922 when we had a very violent slump in commodity prices that we then made quite a point of especially inquiring about any contracts for future purchase commitments.

Q. What consideration do you give to the minutes of various corporate meetings such as stockholders', directors', or operating committees', and so forth?

A. Always examine them. No exception whatever.

F. PROFIT AND LOSS ITEMS

Q. Now, turning to profit and loss statements for a moment.

Item one on page 30 suggests that a working profit and loss statement be obtained or prepared in as much detail as is readily available. In that connection, do you prepare your own statement or do you obtain financial analyses and statements that the company may have prepared?

A. To the utmost extent that I possibly can utilize material that will have been prepared by the company, I do so.

I always ask the men to be sure to get the company's statements.

Q. Do you then verify those statements to the books?

A. Certainly, sir. That is an absolute necessity.

Q. Do you make inquiry as to what statements they have available?

A. Yes. Always ask for the statements that they have and all that they have.

Q. Now, in item 2, there is a suggestion that budgets, previous annual statements, and monthly statements be obtained? What is the purpose of obtaining such statements?

A. Well, of course, the purpose there is to determine what fluctuations, or variations, have occurred in the company's business that might point a warning finger to the auditor. If there were budgets prepared, I know that that doesn't always happen, but if budgets were prepared and there was a considerable departure from the budgets, why, of course, there would be a great many questions that would bristle

outright immediately and, in respect to statements for prior years and, of course, that would be—we are now thinking, I think, of a first audit when we had no prior connections, why the company's history, of course, is the thing that wants to be investigated and that would help to tell something of it.

Q. What investigations do you make of differences that these comparisons uncover? What do you do?

A. Well, it would depend, wouldn't it, on what the differences were? If I were to refer to public utility companies, why most operating public utility companies have an ironclad rule that the manager of the local office shall explain why there are these variations between this month this year and the same month last year and he has to do a great deal of investigating and maybe sometime working his ingenuity to explain why that is.

Q. Would it be fair to say that you attempt to satisfy yourself as to the reason for the variation?

A. We would always satisfy ourselves that there was a reason for it and that we did get the reason.

Q. Under sales and cost of sales, item 3 outlines a procedure for testing allowances to customers for returned merchandise, for claims, and rebates and the like. Now, what is the importance of such an analysis? Do you make it, customarily, also?

A. You use the word "analyze" there. I wonder if analyze means the same to you as it does to me.

Q. Let's change it to test.

A. Examine or test, yes, that's—well, that's another piece, I should say, of this internal check and control device. If it were to happen that the cashier, for instance, was the man who did, whether he was authorized to or not, who did approve, okay, these credits to customers' accounts, I think I would certainly get, immediately, very suspicious and that would mean in such cases as that that we would have to explore the full subject with a very great deal of thoroughness because it is perfectly obvious that the possibility of a cashier receiving incoming cash and retaining it and fixing up the customers' accounts by applying a credit for price reduction or for some theoretically returned merchandise or something of that sort, it is just a little too obvious.

Q. Now, speaking of the profit and loss statement, generally. What, in your opinion, is the responsibility of the accountant for the proper classification of expenses and income? What procedures do you use to verify the classification?

A. Well, I believe that we expect that the account shall be stated correctly and there ought to be, of course, an intelligible and helpful classification of expenses. I say there ought to be. There isn't always but there should be and I think that the accountant is under the obligation to see that if there is such a concept that it is adhered to with a good deal of closeness.

Q. How do you determine that? How do you go about it?

A. By examining the method of distribution. Let us say one of the primary methods of distribution would be the columnar arrangement of the voucher register and by observing by the test device that vouchers which should be, let us say, charged to expense account No. 1 are so charged and that those that should have been charged to expense

account No. 5 are so charged. A test in the progress of the examination of the books of entry in which that classification is made originally.

Q. Now, do you examine the original records for large entries, particularly?

A. That, of course, would be one of the things that we would think of first. That is, the largest item on the page would almost inevitably be the one that is examined. I would not want to limit it to large items, but any prudent man would look for a big item first.

V. REVIEW OF THE ENGAGEMENT

Q. Now, turning to the question of drawing together the working papers and preparing financial statements and reviewing them. In your practice, who is responsible for doing this and preparing the preliminary statements?

A. Well, we expect our senior in charge of the job to do that thing, to review all the work that has been done by those whom he has had as assistants and to see that the statements are prepared and that a text of the report in first draft is prepared and if there is to be a formal certificate, that a first draft of a certificate is prepared and that the papers are all properly indexed and that in general the job has been brought as far to completion as it can be before it is laid down on the desk of the partner who is in charge of it.

Q. Is it customary for you to have the statements and working papers reviewed by anyone other than the person actually supervising the audit? That is, the senior in charge?

A. Yes. Our practice is for one of the partners to do a very definite review of the papers.

Q. Could you outline briefly what sort of a review that is? What the steps are?

A. Well, the device that I adopt is first to go through all of the papers and see if in my opinion they have been well prepared by the junior. They ought to and do show all of the evidence and information that should have been got.

Q. Does that include detail review of each working paper or a general look at them or some test checking?

A. It includes an examination of all the papers to the extent of reading them. When you ask about test checks, why I just haven't got up to the point of talking about the test checks.

Q. Excuse me.

A. Then I am always sure I read the abstracts of the minutes over very thoroughly, and I will have always at my right hand a paper on which I make my memorandum on review of papers, and every kind of question that I think I want to ask as I go on down through the papers is asked, and when I have got all done, why I will see that the papers have been all keyed in, as we use the phrase, to the trial balance, and that trial balance then is the thing that I usually check by myself and I think each of us, who are partners, do the same thing.

We go back to the trial balance and check that in definitely and directly to the balance sheet and similarly to the income statement to see that we understand clearly, ourselves, what accounts in the trial

balance are assembled into the more—rather more condensed presentation that will inevitably be shown in the balance sheet and the income statement.

Then, when I have done that, I think, generally, I have said what I have done as to the detail I want, I will take my memorandum on review of papers and ask the senior to come in and I proceed to ask him the questions that I asked myself on that paper and get answers to them.

Q. That is, you do your looking at the papers and make up your questions without the senior being present and then call him in and ask questions?

A. Yes. There is no use having him stand around while I am turning over the papers. I work it out myself and then ask him to come in.

Q. One other thing. Starting with the trial balance do you key that back to the working papers; that is, trace the amounts back to the subsidiary papers?

A. That is one of our requirements for the men to do.

Q. Do you do it, or does the senior do it?

A. The senior has the obligation to do that. I will find his check marks on the papers, and I will find his check marks on the trial balance to indicate he has done it.

I will grant, I often turn back and look at the papers themselves and say:

Well, let's see, why does that account go into that account on the trial—go in that account on the balance sheet?

and will turn back to the working paper itself, the detailed working paper.

Q. Then you look for the senior's checks on the trial balance which would indicate corroboration to the working papers?

A. Yes. That would be the thing that I would certainly want to observe and if they weren't there I should want to know why not.

Q. And the purpose of that review is, in general, what? Just to restate part of what you have said.

A. Well, I have said so many times that I suppose I am tiring you, that I think that all of this work is done so that we who take the responsibility of signing reports may feel very sure that we have an opinion. That is how we get the information on which we believe that we are privileged to form an opinion.

Q. And do you have an informed opinion?

A. We form an opinion on the basis of the information that we derive from that review of the working papers.

Q. I am sorry. I said an informed opinion.

A. Yes; indeed. That's the information that gives us the informed opinion.

VI. THE REPORT OR CERTIFICATE

Q. Now, I believe you said a moment ago that a senior very possibly would draft the form of certificate. Would you review that always in the course of your—

A. (Interposing.) Of course, I would review it and almost inevitably, knowing myself as I do, I would redraft it in some respects.

Q. Who is authorized in your firm to sign certificates?

A. None other than the partners. Some one of we four partners signs every certificate and every report.

Q. Is it your practice to use a certificate along the lines of that set forth on page 41 of the bulletin, where you have made an examination of the general character set forth in the bulletin?

A. Well, in general it is; yes. I think that that's the fairest answer to make now. I do not, nor do any of us in our organization, feel any obligation to adopt, with the uniformity that I know some accountants think should be adopted, this specific form of certificate.

For instance, that terminal phrase, in, I think it is the first paragraph:

but we have not made a detailed audit of the transactions.

Now, we use that sometimes but very often we do not use it, because we have made what we believe to be a detailed audit of the transactions and I must say here, if I am to be altogether candid about that, that I have read certificates in which the accountant has said, "We did not make a detailed audit of the transactions," and I have said to myself, "And why not?", because when businesses are so small that it is quite out of the question to have what anybody could seriously consider as an adequate system of internal check and control, then I think a detailed audit is just about required. But I say that that is in cases where the company, the business, is small.

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

A. Well, I think that people do believe that when informed, capable, competent auditors have made an examination of the financial affairs of a corporation, that they should be willing to say that they have done so and have formed an opinion on it and I think that that is what the function of this certificate is, to advise whomever reads it that auditors, whom they may reasonably presume to have been competent, have made an examination of the affairs of the company and that in their opinion the statements to which the certificate is appended do fairly set forth the condition of the company.

Q. What impression do you—is that the impression that you attempt to convey by the use of your certificate?

A. Yes; yes.

Q. And now, looking at this form of certificate, is it your understanding that the second sentence of the first paragraph on page 41 is intended to be a reasonably comprehensive statement as to the scope of the audit?

A. Well, I think it is intended to be.

Q. Scope of the examination in conformity with the bulletin?

A. Yes; I think it is intended to be and it will be just repetitious, if I say that.

I made a little pencil note here, "If we have made a detailed audit why we do say it." And I think when you have said "the second sentence" you mean that whole collection of clauses that began, "In connection therewith" and ends, "But we did not make a detailed audit of the transactions." As I have indicated before we often do make a detailed audit of the transactions. I think in those cases a detailed audit should be made, and so in those cases we just completely drop that terminal phrase off.

Q. By a detailed audit you mean there an audit that is not based on sampling of the records but is based on thorough analysis of all of them or just what do you have in mind?

A. I have in mind there a detailed audit of cash transactions. I think I would perhaps limit it there. Because if we are talking now of a merchandising and manufacturing business I think it is quite obvious that we would not go over all of the operations that have been carried on through the period, but I think I would also want to say that where, for instance, we have been examining an investment company which is a rather simple sort of thing, to use as an illustration, that it is a fair thing to say that we have gone over all of the transactions that have to do with the financial condition of the organization.

Q. Would it be fair to say that by detailed audits you mean an audit of all of the cash transactions and perhaps a larger, or more thorough sampling of the remainder than in the case of a nonetailed audit?

A. If we are talking about manufacturing and merchandising businesses; yes.

Q. And in case of such things as an investment trust, it would mean pretty nearly a complete audit?

A. Yes.

Q. Of the transactions?

A. Yes. That would be a fair expression of my meaning.

Q. Now, do you believe, Mr. Horne, that any material omissions from the program indicated in the bulletin should also be indicated in the accountant's certificate?

A. Yes. Of course I do.

Q. Assuming the conditions in question are present.

A. I would have this comment to make, that if they were material omissions, that is, if I felt they were really material, I am very inclined to think that a certificate could not be issued. In that case I think you would have to go ahead and make up the material omissions before you could issue the certificate.

Q. Would that be with respect to steps which the bulletin speaks of in optional terms?

A. Maybe that is not—I think that certainly where optional forms are indicated here, that there would be no material omission if you adopted one of the options. I certainly think that that would be my understanding of what would be meant by anything if it was comprehended within the term of optional.

Q. And similarly, as to recommended but not required additional further steps? For example, there are several places where it says:

In certain circumstances do something else.

A. Yes. If the circumstances did not exist and we did not find it necessary to do those things, I would not believe that those were material omissions.

Q. But as to the things which we described earlier in the day, is it minimum procedure?

A. I think if there was anything short of the minimum procedure I would say, as I said before, that I think the certificate ought not to be signed. That is, the deficiency should be made good before the certificate would be given.

Q. And do you in the course of your engagement with a particular client enter into any sort of a written contract?

A. Well, correspondence, of course, can constitute a contract. We never do have any arrangement by way of formally—"this contract witnesseth," and that sort of thing. There, of course, are a good many engagements taken on the basis of correspondence. There are also a good many taken on the basis of telephone conversations and that is all there is to it because we know them well enough.

Q. Do you prepare for your own records any memorandum as to the audit indicating what is to be done or what is not to be done?

A. Always a memorandum of what is to be done and I suppose if there were a case in which we want to make clear that we are not going to do a detailed audit, why, we would say it was not to be done; yes.

Q. Would any limitations on the scope of your work that had been agreed upon by you and the client be contained in such a memorandum?

A. Yes. If there were limitations agreed on, that would be contained in that memorandum, certainly.

Q. Would you feel that any such limitations are also to be carried over in the certificate? That is, if you agreed to do or not to do something.

A. Well, I think we are thinking now of some things that I can hardly conceive. I am thinking of a case where we do a very limited amount of work or have so done heretofore. This particular company, at the solicitation of the treasurer, wished to have what he called a treasurer's audit and we have worked out such a thing as that.

There was not a willingness on the part of other officials to have us make an examination of the company as a company.

Now, of course, in such cases we do not issue anything that could, by the remotest sort of thought, be conceived of as a certificate. We do not certify to anything. We simply write a letter, sometimes of quite a number of pages, on the subject of that particular examination, but certainly that is not to be given to outside parties and I might say in respect to that, that because of the fact that we have learned that some people have said, "Well, now, we understand that your auditors are so and so" and an affirmative answer has been given, why we are discouraging very much the continuance of that sort of limited audit so that hereafter I think we shall do at least an examination such as is comprehended here in this bulletin.

Q. Speaking now of statements which are going out to stockholders, generally, or to be filed with us. Do you feel that any limitation on the scope of the audit should be contained also in the certificate?

A. If there were a material limitation; yes.

Q. And if it were too material, as you said before, you wouldn't certify it?

A. There wouldn't be any certificate.

Q. Now, looking at the form of certificates again, what language in there indicates, or is supposed to indicate, that there has been no material change either in accounting principles followed or in the manner of their application as compared with the proceeding period?

A. Well, the language is—

in accordance with accepted principles of accounting, consistently maintained by the X Y Z Co. during the year under review.

and I do not like the phrase “during the year under review,” and I do not think that I have ever used it. Because, if it is not consistent with the year prior to the one under review, why, I think we had better not say that at all.

Q. What sort of language do you use to indicate that?

A. Well, almost invariably it is consistently maintained and you can stop right there. That is, it has been consistently maintained for a period of years.

If it has not been, why, I think that the thing to say is in an affirmative way that there has been a change in procedure in respect of whatever has been changed and let that stand in there as an explanatory word in connection with the opinion of the accountant.

Q. Now, looking at the bottom of page 40, the introduction of the accountant's report. It is indicated there that matter may be included in the accountant's certificate or report or in the statement for the purpose of being either merely informative or to state limitations on the scope of the auditor's work or to indicate dissent from particular practices of the company.

Just how would a reader distinguish as to particular matters, the purpose that is intended? What practice do you follow in that connection?

A. Well, I think the reader would have to judge, would he not, by the form of the language you use, and that would depend upon the skill in the expression that the author of the report or certificate had.

I don't think that I can say any more than that. One should explain carefully what he means, and if he doesn't, that's too bad.

Q. Let's take an illustration. Suppose you have certain language such as “inventories have been certified as to quantity, quality, and condition,” or leave out quantity, if you will, “by responsible officials of the company.” If that appeared in the statements themselves or in footnotes, would there be any different inference to be drawn than if it appeared in the first section of the accountant's certificate under the scope of the audit or if it appeared in the opinion paragraph?

Would you use that—put it in one or the other of those places to imply something different?

A. I think I would make a distinction. I think I would very definitely make a distinction in my own thinking.

I wonder if the man in the street would make, or understand, any distinction? I think to follow your thinking there, as I understand it, if that were stated in the body of the balance sheet, I think it would be fair to say that that was simply informative. That is, that would be just an extension of the information that the inventories were stated at cost or market whichever is lower and we would go on a little further, I think, and the statement would be that the company officials had made a particular point to certify to the accountant that quality, quantity and condition were as stated.

If the accountant should put it in the first paragraph of this standard certificate, I would think the accountant would put it in there for a protective purpose. That is, he would want to get it on the record

that—definitely on the record that he had disclaimed any responsibility for it. And I have had an idea since I have been working over the preparing of certificates, that if I were to work it into the opinion paragraph of the certificate, that I would very definitely want to disassociate myself from the valuation of the inventory. I think about a hundred percent. As much as I could do it.

Q. Now, looking at that second paragraph of the opinion:

In our opinion, based upon such examination.

Do you feel that the phrase “based upon such examination,” is a qualification, in your opinion, limiting it to the scope of the examination as set forth in the first paragraph?

A. Well, of course, it directs attention to the first paragraph. I have never thought that it was anything more than informative.

I think that there was a time, and I can remember it very well, when accountants were supposed to, and sometimes did, say “certified correct, so and so, C. P. A.” Now, we have gotten away from that all-inclusive kind of certification so now we want to make it very clear that this is an opinion and not an assertion of positive determined facts, and I believe that we have come around to the feeling that we are under an obligation to state that we have done work which justifies us in having an opinion.

I would accept your phrase of a few minutes ago, “an informed opinion,” and so we say here that in our opinion, and it is based on information, the accompanying balance sheet, and so on.

VII. GENERAL SUGGESTIONS AND COMMENTS

Q. Now, the suggestion has been made that a corporation should rotate firms of auditors at frequent intervals. Have you any opinion as to the desirability of such a practice?

A. Yes; I have an opinion. That is quite undesirable.

Q. What are your reasons there?

A. Well, it seems very definitely to me, from my experience, that this matter of auditing companies, the auditing of companies, is a thing that is done very much better the more one knows about the company and that no matter how much one tries to inform himself at the first time, that there is always something more that can be learned, so that it is perfectly clear to me that the historical background that an auditor gets or a firm of auditors gets from having gone successively year after year, and having done, as is usually the case, all sorts of advisory and consultative work for the company being examined, that's a genuinely valuable asset both to the company being audited and to the auditor who is doing the work and I think that that's sacrificed almost entirely, perhaps it is safe to say entirely, when there is this rotation device.

I have seen the rotation work out and it hasn't worked out very well in cases that I know of.

My belief about that is that there is intangible value that is lost—that is worth much more than the advantage, the theoretical advantage, that might come from, let's say, the avoidance of an auditing firm going stale on the work so that I have my mind very definitely made up that the rotation of auditors is not a happy idea.

Q. How do you square that with the thought you expressed earlier, that some rotation of seniors might be desirable?

A. Well, we are now talking of the firms, aren't we? And I think it is a good thing within the firms for a different partner to take up at times and that is the thing that happens with us quite frequently. It will usually come about, as I said this morning, in respect to rotation of seniors, that one partner will find a big load of work on him at one time and so another one who isn't quite so heavily loaded will take up an engagement that the other has had theretofore.

That, I think, provides a sufficient assurance of lack of staleness within the firm so that I think that the odds are all in favor of going on with the same firm of auditors even though I am perfectly willing to get some of the engagements that might come from the rotation device.

Q. Is it customary, Mr. Horne, for a representative of your firm to appear at directors' meetings or at stockholders' meetings at which the audited statements are presented?

A. In the margin here I have said, "not customary." "It has been done." "Is desirable." And I think that distinctly expresses the whole thing.

I have been at both stockholders' meetings and directors' meetings under those circumstances. I haven't done it as a matter of routine by any means.

I think it is a good idea.

Q. Would your presence include the right to speak as well as to be spoken to?

A. Yes. In fact, I wonder how they could keep me quiet in a case of that sort.

Q. Does your firm make it a practice to send copies of the reports to the directors in advance of the meeting? Do you think that would be desirable?

A. I think it is a little interesting that in one case we do. But I think it is only fair to say that we do that just simply by agreement with the treasurer. He doesn't want to distribute the reports himself, so we do it for him.

I think it is probably desirable, though I don't think that there is enough demand for it to make me have a single bit of prejudice one way or the other unless, of course, that there is a complete degree of dissension within the organization.

It would seem to me that if an organization is going along harmoniously that the outside auditor might very well address his report to the board of directors and send the whole works to the president of the company and let him distribute them around.

Q. Well, to be sure that the directors obtain it and have adequate time to study it beforehand, wouldn't you think this process of requiring the auditor to send the reports directly to the directors might be of some assistance?

A. Yes. Of course, the directors wouldn't have to read them.

Q. No. Is it your practice to send the management, or the president, enough copies so that each director will have one?

A. Well, we always ask how many copies are desired and I think that in one case, at least, I wonder who in the world gets them all, but I do not think that that is the incentive behind the number of copies that are asked for.

It has never occurred to me, until this particular hearing, that there would be any thought of serving a copy of the report on each separate director, because I don't think that—I don't think I can think of a case in which it has been done.

In fact, this case that I spoke of, I think that there are some directors that do not get them. There are a certain number of reports that we send and those persons that get them are all directors. I think that they are the ones who have a lively current interest in the corporation, who are, so to speak, the executive committee.

Q. Do you feel that auditors should point out in the statements they prepare significant developments, or changes, in the period audited? Do you analyze those changes and make any recommendations? Do you include them as part of the statements going to stockholders or only send them to the management? What is your feeling on that general problem?

A. Well, I think that is a rather large order. Of course, if we are talking about the kind of report that I believe is comprehended by this bulletin, which usually is that short report and the balance sheet, the statement of the surplus and the statement of income, I think that we would probably be criticized very severely if we were to express ourselves to such an extent as that.

However, that is not the majority of our cases. We usually do render a long report. I say usually, and I think that is so.

Q. On the basis of an examination such as is contemplated here?

A. Yes; well, yes. I think even there. Because we have—we do rather sell our clients the idea that we can make suggestions that are worth while, and so in most cases we do try to suggest the things that seem to us to be worth while speaking to them about.

I think that in one of these questionings you suggested that the statement of application of funds might be such a statement that could be submitted, and I think that that might be implicit in the case of the question that you asked me.

Well, now, we have at times submitted that statement and I think in some cases it has been very useful and I would underscore the "very" in those cases.

There are other cases in which I feel that that got completely over the head of those to whom the report would go. They just would not know what it was about and what it was for.

I am inclined to think, in respect to that form of statement, that it needs to be spelled out in one-syllable words, and even then it is not understood by those who get it.

Q. Do you prepare such a statement; that is, a statement of application of funds for your own use in connection with engagements?

A. Yes; I think it is a safe thing to say that invariably we do. We make a comparison and work out the differences more or less roughly in a statement of application of funds.

Q. Now, another suggestion has been the adoption of the natural business year. What thoughts have you on that?

A. Well, of course, the accounting profession, as one man, rises and applauds the idea.

We think very well of that. In fact, I think we got talking about it long before the profession arose en masse and demanded it.

Q. What advantages would it have, Mr. Horne? How would it help you?

A. Of course, it has the obvious advantage of distributing our work around so far as we are concerned and I think it has a very real advantage in the case of the business that is being served.

It seems to me the argument is perfectly clear and hardly needs any amplification that at the time when the season's business is done, that is, in businesses that are seasonal, and many businesses are, that is the best time, as the old phrase went, to take account of stock, not only merchandise inventory, but all of the elements of value that constitute the company's assets and liabilities. And, in fact, in the company in which I worked before I came into public accountancy, why, we invariably did close our season in the middle of the spring and middle of the fall and made the fiscal year ending at the middle of the fall.

Q. Have you made any analysis of your own clients to determine whether your peak loads would be—could be reasonably reduced by the adoption of the natural business year?

A. Well, not definitely. I would—I think I would like to say that we did, but we really haven't. Although, of course, in a general way we have that rather clearly in mind.

Q. You feel it would distribute your peak load?

A. It would distribute the load. We certainly have a peak at the end of the year and the beginning of the new year and we would like to diminish that. It would certainly ease up on the office manager's problems with respect to idle time of staff.

Q. Now, speaking generally again. Would you say that present-day auditing procedure is mostly concerned with determining that generally accepted accounting principles and conventions have been followed in the accounting records of the company?

A. Well, if I were to answer that categorically I would say "no," but I would like the privilege of extending my remarks, so I have written something I would like to read into the record.

Q. Please do.

A. Present-day auditing procedure is directed toward ascertaining that correct (and generally conservative) accounting practices have been followed by the business that is being audited. Correct accounting practices are those that protect the assets and provide accurate analyses of the business operations.

Auditors generally are of an inquiring turn of mind. They are alert to observe points of weakness in the office organization. If those weaknesses indicate possibilities of error they watch for errors. If the weaknesses indicate possibilities of dishonesty or fraud they are specially on guard.

That should be, and that is, basic to present-day auditing procedure. The procedure followed by competent, alert auditors is successful in detecting error and fraud. The errors that are detected and corrected never are heard of by the public, and often are not long remembered by the clients—because the auditors who found them and had them corrected were doing only their normal work.

One case comes to mind in which the statements prepared by a company showed that the business had been more than usually profitable during the year then ended. In the course of the audit it was found that the company's staff had made entries for the purpose of correcting some overvaluations of the inventory as originally recorded. But, in making those entries the office staff had made them

in the wrong direction (thus anticipating Douglas Wrong-way Corrigan). The auditors found it necessary to ask the controller of the company to reduce the inventory and the income by about \$200,000.

Aside from the errors made by bookkeepers and found by auditors and the dishonesties and frauds cut short by auditors, there is another service to business rendered by the professional auditors that is of incalculable value.

That service consists of the deterrent effect of the annual audit—on carelessness and laxity and on dishonesty. The bookkeeper who knows that his errors probably will be tabulated and brought to the attention of his superior will make fewer errors. The crooked-minded cashier who knows that (even if he never takes a vacation) some gimlet-eyed auditor probably will ask some unanswerable questions, will seek another field for operation.

Thus the auditing profession serves business in at least three ways: (1) In detecting and correcting error and fraud; (2) in educating bookkeeping staffs in correct methods; and (3) in the deterrent effect as to error and fraud. And the benefits to business and investors resulting from the last two items are greater than those relating to fraud because the occasions for such benefits are so very much more numerous.

Q. Now, going through the balance sheet and the income statement more or less item by item, could you point out the items which your auditing procedure verifies to your own satisfaction by tests which are independent of the accounting records and of information furnished by the officers and employees?

A. Well, do you know I think that pretty nearly covers all of them.

Now, that may sound rather sweeping, but I think there is an implication in the question that some of it is, so to speak, paper work and I hardly think that it is a fair thing to say about any part of the work that we do in the verification of balance sheets.

If we go down through the balance sheet, and I am, just for purposes of convenience, taking this form that is shown in here, so far as cash in banks is concerned, it is the invariable procedure to get a confirmation from the banks.

So far as cash on hand is concerned, always the imprest cash fund is examined.

The next item is marketable securities, and we always examine the securities, or if they are in the hands of a custodian, why, we get a certificate from the custodian detailing what securities are held.

So far as notes and accounts receivable are concerned, I have answered before that we always insist on examining the notes and they are not essentially different from the securities so that they have been examined.

Accounts receivable are the subject of considerable discussion in this case, but I think it is a fair thing to say that if there were no records there would be no auditors and the records are just, so to speak, the accounts receivable.

There is in the whole accounting process enough of corroboration of the facts that there are accounts receivable.

This matter of—as I think I mentioned before, the manufacture of goods, the passage of the goods out through the medium of sales,

the collection of funds from the accounts receivable into the cash, the observance of this whole chain would indicate that the accounts receivable feature had genuine existence.

So far as inventories are concerned, we have talked about that a great deal and we have always done enough work to satisfy ourselves that the inventories are fairly stated.

So far as these other current assets that are here, why if we are thinking of indebtedness of affiliated companies, we will find that the company is an affiliated company and that is taken up; since in this case it is an asset, in that case it will be a liability.

Much the same thing could be determined in respect to indebtedness of stockholders, directors, officers, and employees and in those cases they often would be currently confirmed. If they amounted to anything of substantial amount and those persons were so conveniently accessible for the purpose of confirmation, why the logical and natural thing to do would be to ask them to verify the fact that the account was as stated.

The next item that is stated here is another class of investments. They would all have been examined when the marketable securities were examined so we would have seen those.

And to the extent that the securities themselves are evidence of the ownership of the asset—that has been confirmed entirely outside.

The next class that is here is property, plant, and equipment. Well, the property and plant are there. Almost invariably we are working in the plant or if we are not we can go and look at it and I have said before we encourage our men to see that the plant is there.

Q. Does that include plants that are not at the principal place of business?

A. I grant that that is an exception and yet, of course, there would be in that case the company's stationery going out to all of its customers saying, "We have plants at this and that and the other place," and very often the stationery will have pictures of those plants on it and we will find reports that come in from those plants and there have been expenditures for maintenance; insurance has been paid on them and taxes have been paid on them. A myriad of items will come into this secondary circumstantial evidence that will assure you that the plants are there. The other item—the next item below that is intangible assets. If there are intangible assets, of course, they cannot be felt but the record of their purchase, if purchased, can be had and we have corroborated that to the extent of the transfer of names, of title, patents and trade-marks and so on. Even in those cases there might be documentary evidence that we would be asking to see in respect of those items.

Q. Would you verify, for example, patents by correspondence with the patent office?

A. No; I cannot conceive of that. There would be documentary evidence though that would be very convincing and anybody that has done any work on patents as in our office would just shy away from attempting to verify with the patent office.

Under the heading of deferred charges, why one of the things that we have been talking about is insurance. We see the insurance policies and we can do the arithmetic necessary to determine whether there was a portion of that premium that might be carried forward.

In respect to bond discount, we can, and invariably do, find out whether the bonds had been sold at a discount and if they had been, why it is one of our conventions, and a convention that I wholeheartedly accept, that the bond discount should be carried as a deferred charge. Generally speaking, I cannot think of anything that we do not get some confirmation on other than what has been by some of the newspaper correspondents referred to as paper work. And truly the same thing is so about liabilities.

There is, with respect to notes payable, often a definite confirmation of the notes payable. Not always, but often. And with respect to accrued expenses, they are calculable.

With respect to funded debt, you may just leap on, rather than go on with the detailed story about every item, we will get definite confirmation from the trustees as to the funded debt and the description thereof and with respect to the capital stock, if for convenience, we include that among the liabilities, why almost inevitably there will be a transfer agent or registrar and we will ask to have certified the amount of shares outstanding and if there is not such a transfer agent or registrar, why we will ask for the capital stock records and work over those ourselves and determine that the missing stock certificates are those that, if added up, come to the outstanding capital stock.

Q. And as to the surplus?

A. Well, as to the surplus, that is a matter of computation.

Q. Now, turning to the profit and loss statement. What items on there do you include in this group?

A. Well, of course, with respect to sales, there is the routine that must, of necessity, be followed by the company for reporting sales and we have always gone over that, having gone to whatever device of sales books they have.

Q. And those are all records of the company, are they not?

A. Those are records of the company, that is true, but, of course, those sales have been posted to accounts receivable and the accounts receivable will have during the year become cash, the cash will have come into the cash book and will have gone into the bank and it will have gone out again in payment for wages or raw materials and so on.

Q. Are there any items in the profit and loss statement you would like to speak of?

A. Well, I spoke of sales. Of course, we can confirm the purchase of materials, the cash has been disbursed to acquire the materials, the inventory has been there, we have seen such of it as has been bought and not used.

Q. How about the expenses?

A. Oh, the expense, of course, would be vouchered and we would have test-checked the vouching of it.

Q. Those are again, however, the records of the company, are they not?

A. Yes. Those are records of the company. They are records of the transactions, if you don't mind my saying that. That is what they are.

Q. They are records of a transaction?

A. Well, of each individual transaction, yes. When we see a salary check that is paid to John Brown and we know that John Brown is

the treasurer of the company and he has endorsed the salary check, that is rather conclusive evidence that John Brown got paid his salary and so progressively on down through the purchase of materials and supplies; and if we were to leap on beyond those things, beyond those which we lumped together as expenses, why we have income from investments, which is calculable and we have deductions from income, interest that we would pay, which is calculable, and the basic facts of which would have been determined as I have just outlined so that generally I think that we have about confirmed everything by something other than paper work.

Q. Now, looking again at the form of certificate stated on page 41 of the bulletin. That certificate contains the language, 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 employ this form of certificate, Mr. Horne, do you mean that in your opinion, as a public accountant, the examination made has been sufficient to verify the existence of the assets and liabilities and the authenticity of the transaction?

A. You said those hard words again, verify, existence, authenticity, and I have been saying right along that we have felt sure that we did enough work to enable us to form an opinion that the financial condition of the company was as represented.

Now, I want very definitely to say that we do not guarantee to anybody the existence of anything because that is not what we are certifying to.

Q. Not even the cash on hand?

A. Well, I think that I do not want to say that I guarantee that to anybody because definitely I am not an expert on counterfeits and that is clearly possible there. So that when it comes to verify, which you legal gentlemen have a way of putting a tight meaning to when you want the tight meaning attached to it, why I, a little bit, withdraw on verify.

Q. Would you say "establish to your own satisfaction"?

A. I would say that.

Q. And you would say, I take it, that you are certifying you made such an examination as in your opinion as an expert was necessary to enable you to give an informed opinion?

A. That is the way I would like to say it.

Q. Have you anything that you would like to say Mr. Horne?

A. No, I do not think I have. It seemed to me to be an apt place to put my little speech in a little earlier.

Mr. WERTZ. Thank you.

The EXAMINER. Any questions, Mr. Henderson?

Mr. HENDERSON. No.

The EXAMINER. I would like to ask you one question. You objected to Mr. Wertz's use of the word "verify." What do you think is the purport of this certificate in the minds of the public?

The WITNESS. Well, of course, that's a question that I have supposed might be asked; and I do not know what the mind of the public is.

I am inclined to think that the implied reply to your question is that the public has come to believe that accountants do verify, do warrant. I think that accountants have been doing all that they

reasonably should do for a good many years to make clear to the public at large that there are limitations on the things to which we can certify. That series of letters which were published—letters between committees of the institute, institute of accountants, and of the comptrollers' institute and officers of the stock exchange back some few years ago, I think that among accountants we refer to it as the gray book, that thing, that series of letters attempted to make perfectly clear that there were limitations and that if the public at large felt that this was a complete and unqualified approval of everything that could be thought of in connection with the company's affairs, why it just wasn't that.

The EXAMINER. Have you any suggestions as to how the public might be, shall we say, educated as to the scope of your audit or the scope which you intend your certificate to cover?

The WITNESS Well, I think that I have not come, Mr. Examiner, to any definite conclusion to what more we can do about such education. I have a belief that these two committees that I said I had been working on, one in the institute and one in the New York State Society, may get around to making some pronouncement which ought to be heeded by the public. Whether it will or not, of course, is a thing that nobody can prophesy.

The EXAMINER. Do you think a change in the wording of the certificate would do it?

The WITNESS. I don't know what change to suggest; that would be my difficulty about it.

The EXAMINER. In other words, it is a matter of the public reading your certificate carefully instead of just taking it for granted.

The WITNESS. Yes. I think that is so. One thing I have said, and I don't know why I should not say it again, is that I think that the certificate is not really expressed in what might be called the American vernacular. Now, why it got in this form I cannot say very definitely, but I do think that if it were written by men whose entire literary training, if you speak of it that way, has been acquired wholly within the United States, that they would almost inevitably use other language, but I cannot overlook the fact that in all accounting work the traditions, and I think I might get a little enthusiastic and say the glorious traditions, of British accountancy organizations have a great deal of influence and so I think that has probably worked itself into the certificate. But the lack of comprehension, if there is a lack of comprehension, as I think all of us surmise on the part of the American public, may be attributed to that; its rather unfamiliar structure, sentence structure.

The EXAMINER. Thank you.

Anything further?

Mr. WERTZ. Nothing further.

The EXAMINER. Thank you very much.

(Witness excused.)

The EXAMINER. We will adjourn until 10 o'clock at which time we will have Mr. Charles B. Couchman of Barrow, Wade, Guthrie & Co.

(Whereupon the hearing was adjourned until 10 o'clock a. m. March 3, 1939.)