

AFTERNOON SESSION

D. INVENTORIES

Q. (By Mr. WERTZ.) Mr. Klein, I would like to turn now to the question of inventories for a while. In your opinion is an accountant responsible for the pricing of inventory in accordance with generally accepted accounting principles?

A. Yes. That is, he is to make sufficient inquiry and tests to satisfy himself that such pricing norms have been observed.

Naturally, if the engagement expressly eliminates such inquiry and testing as comes within the scope of the auditor's work, that fact must be clearly and expressly set forth in the certificate.

Q. One of the common methods of pricing inventory is cost or market, whichever is lower. If a determination of market prices is necessary in connection with that, what is meant by market price? How do you determine it? Is it necessary to check to see whether the market price used is appropriate in terms of quantity, quality, and so forth?

A. Market price depends upon circumstances. In all cases, it must be with reference to the client's market.

I do not suppose that you want me to tell you that the market price is the result of the forces exerted by a willing buyer and a willing seller.

We require certification from responsible officers as the first step in the process of becoming satisfied that the prices used are correct and that the grade and quantity are as shown in the inventory.

We then independently test the validity of the prices by reference to purchase invoices and purchase commitments for a period shortly prior to the audit date, and for the period thereafter up to and through the time of the examination. Some recourse is had to quoted prices in trade papers, although it is known that such prices are frequently inspired.

Reference is also had to the client's selling prices with due regard to selling and administrative expenses and normal margin of profit. As to grade and quality, we seldom take any responsibility, nor do we believe that, under ordinary circumstances, except in very few instances where staples are involved should such responsibility be assumed by the accountant.

The Federal revenue authorities have dealt with the question of inventory at market at least since 1917. I refer you to article 22 (o)-4 of regulations 101, without reading therefrom.

Q. And when you said a customer's market, did you mean a buying or selling market on the part of the customer in pricing inventory at cost or market?

A. No; the client's buying market, where the selling market is referred to, it is the selling price realized by the client, less the factors that I referred to.

Q. Now, when you say you take no responsibility for quality, do you mean that in determining whether prices are applicable you do not determine whether the prices refer to the quality of goods which the client has?

A. Not precisely that. We refrain from assuming responsibility that the quality is as represented. Despite that fact, we try to assure ourselves by physical tests as well as by references to records, that

the qualities alleged to be in the inventory are those which should be there and that the prices with reference to such qualities are the prices that should be applied.

Q. That is, assuming you accept the quality as indicated, do you then take responsibility for using market prices which refer to such qualities, not to some other quality of the goods?

A. Let me illustrate. I referred to price statements in trade papers. Take the quoted prices for cotton with respect to the grade known as middling. If a client has on hand longer staple cotton the price differential is set forth in tables and we apply the higher price to the alleged quality. We do not attempt to open the bales which are supposed to contain quality XX2, let us say. We do try to test the correctness of the alleged quality by reference to the markings on the bales and in comparison with receiving records, purchase invoices, et cetera.

Q. Confining ourselves for the moment simply to price. If you accept, and let us accept for this purpose the designation as to quality the client has furnished you, or that you have determined. Given that quality do you then take responsibility for seeing to it that the prices used have reference to that quality and not to some other one? Just on the question of pricing.

A. I would not say that we take legal responsibility but we do take professional responsibility to do all that is necessary to satisfy ourselves that there is a one-to-one correspondence between the accepted quality and the correct price therefor.

Q. That is what I had in mind. What procedure—

The WITNESS. Off the record for just a moment?

Mr. WERNTZ. Surely.

(Discussion off the record.)

Q. (By Mr. WERNTZ.) What procedure, Mr. Klein, do you follow in determining that goods held or shipped by the company on consignment have properly been treated in the inventory?

A. A certificate from responsible officers is required. If the records disclose the fact that goods are being held for others or have been shipped out on consignment, it is relatively a simple matter to determine whether or not such goods have been properly treated in the inventory.

Difficulty would arise if the records failed to disclose the relevant facts, in which event even a physical test of the inventory might fail to disclose the facts under discussion.

If the independent auditor's staff is present during inventory taking there is somewhat more likelihood that the existence of both types of items would be found by the auditor.

We use among other records in connection with this phase of the examination, confirmation of receivables, scrutiny of the receivable accounts for the type of charges contained therein, and the payments made, remittance letters and similar documents.

Q. You mentioned, I believe there, confirmation with the consignors and consignees. Would you send confirmations to persons as to whom the record showed no goods on consignment if the company had had a regular course of dealing on consignment with those people?

A. Our practice is that where we confirm, if there are any transactions during the year but no balance at the end of the year, no open account at the end of the year, we would try to confirm to the same extent as the testing of the still open or active accounts.

Q. I see. Is it customary in your practice to make any other tests than those you have indicated to determine whether the company, in fact, owns the inventory which you know to be on hand?

A. I suppose you refer to all inventory items and not merely to consignments?

Q. Not merely to consignments.

A. Tests are made to determine that purchase invoices for goods in inventory have been entered in the account. Scrutiny of entries of purchase invoices after the close of the balance sheet or cut-off date is the usual procedure for determining this type of item.

Frequently items in the inventory can be checked back to purchase invoices by lot numbers and other identification marks. Requisitions from departments, purchase orders issued by the client, receiving records also may furnish a clue, as also such documents of title as warehouse receipts.

Q. I believe you have outlined in part, perhaps, the answer to the next question but I would like to ask it in any event. What is your customary procedure to determine that there have not been included in sales goods which have been shipped in a subsequent period or vice versa and what evidence do you rely on in this connection?

A. It is part of the established examination procedure to test that merchandise represented by recorded sales prior to the close of the audit period actually, (a) has not been included in the inventory and (b) that such sales do not belong to the subsequent period.

Direct confirmation of accounts receivable would be one means of disclosing the true facts. The established procedure also includes examination of shipping documents and sales order registers, both shortly before and shortly after the cut-off date. Concentration of sales toward the end of the period as well as relative decrease immediately thereafter is examined into as possible suspicious elements. Unusually heavy returns recorded soon after the cut-off date may indicate the need of special investigation.

With respect to items shipped from outside warehouses, the auditor would have to rely primarily on advices from such outside concerns, but direct confirmation of receivables would be equally indicated here as in the case of self-controlled shipments.

Incidentally, those advices from outside warehouses are frequently in the form of consecutively numbered advices so that any gap in numbers would be an indication of a need for such an inquiry.

Q. In order to establish the cut-offs in this connection, you would have to get particular shipments detailed from the outside warehouse, I take it, in order to make the clear-cut separation?

A. Those advices resemble memo invoices: The person shipped to, the date of shipment, the medium of shipment, the description of merchandise shipped. The price would probably not be there because the warehouse would not know, normally, the price at which it was billed.

Q. Now, when you check up the company's calculation of inventory, is it your practice, do you believe it is feasible or desirable to employ comptometer operators?

A. We do. We have a permanent staff of comptometer operators and we engage additional ones at the peak seasons. For this type of work we feel we could not dispense with them.

Q. Now, turning to the purchase side of the transaction, what test do you make to determine that purchases, all purchases of a particular year have been included both in inventory and liabilities and, conversely, that no purchases of a subsequent year have been included in inventory?

A. The invoices are, themselves, examined as the first step. Then, receiving records are examined as to date of receipt, et cetera.

A sampling of items in the inventory is often made for the purpose of locating the purchase invoices. Scrutiny of purchase records; entry shortly after the close of balance sheet date; inquiry of employees who are in charge of receiving and entering functions; certificates obtained from responsible officers. The auditor's discretion must govern the extent to which underlying documents are scrutinized and such discretion in turn is influenced, as in so many other instances I have referred to, by the established system of internal check and control.

Q. Now, if the procedures contemplated by the bulletin as to inventory have been satisfactorily completed, is it your custom to include in the accountant's report, or in the statements, any qualification as to your responsibility for quantity, quality, or condition of inventories?

A. The answer is "no." If it is necessary to qualify we usually state what we have done as, for example, that we have merely tested the arithmetical computations or that we have tested approximately blank percent or blank dollars of the inventory as to price and quantity, or that we have ascertained that by the date of our audit such a percent of the merchandise which had been included in the inventory had been disposed of at prices which justify the inventory valuations.

Q. Am I correct in understanding, then, that you would not make a qualification if you have completed the procedures outlined in the bulletin? I didn't quite get the import of your answer there.

A. I don't like to be tied down to the bulletin for reasons which I think I have made clear. I would put it this way, if I may, that we do not qualify if the procedure which we have employed is sufficiently comprehensive to satisfy us that the representations as to value are substantially correct.

Q. I see. Now, if you include in your report or in the statements an indication that you have relied upon responsible officials for information as to quantity, quality, and condition of inventories, do you feel that this avoids the necessity of making such tests and inquiries as may be indicated by the last sentence of item 3 in the bulletin?

A. The answer is unqualifiedly "no."

Q. What sort of tests do you feel are contemplated by that sentence in the bulletin; the last sentence of item 3?

A. The one which reads, "Make reasonable inquiries and tests, et cetera?"

Q. Yes.

A. Among the tests for the ascertainment of the correctness of quantity in inventory, I might mention the following, and let me say, parenthetically, the numbering is no attempt to indicate the relative importance which depends on the circumstances: (1) That inventory procedure, including the control of tags and sheets, is sufficiently sound and sufficient and is sufficiently well understood by the inventory squad and checkers. (2) That the inventory and checking squads have been adequate and that these squads understood their duties in the established procedures and that they observed such procedure. (3) Comparison of selected inventory tags, or other original inventory data with final inventory sheets. (4) Tests by comparison with quantities on hand (making due allowance for changes between inventory date and examination date) some of the relatively large items, that is, those that are large in quantity as well as those which are relatively large in money value. (5) These are some of the tests that come to mind, they might vary in extent as well as in kind, depending upon the circumstances. The inquiry involves discussion with the person or persons who signed the inventory certificate as well as with some of the people who have actually taken the inventory, not limited to those in key positions.

Of course, the verification of arithmetical accuracy and the fact that the client's squad check and recheck where necessary, are included as steps that we would observe as to whether they had or had not been taken.

Q. Do you feel that such tests as you have enumerated are contemplated by that sentence in the bulletin which reads:

Make reasonable inquiries and tests.

A. I think so.

Q. I believe you indicated that you did review the methods followed by the client in taking inventory. Could you expand on that just a little?

A. You are correct. We do review the inventory methods of the clients and we frequently collaborate in the adoption of the method and in the preparation of instructions with respect thereto and we have sometimes collaborated in orally presenting such instructions to those who actually took the physical inventory.

Now, a well-thought-out plan thoroughly understood by those who take the inventory and rigorous supervision during the entire inventory taking period is a part of such a proper plan. Proper preparation for inventory taking is an essential element. Such preparation consists of a cut-off date, and as I have already stated, of a well-developed plan reduced to writing and thoroughly understood, the use of distinctive forms to control changes both by way of addition and by way of diminution during the inventory period.

This time element has a special application to and significance in cases where parts of the inventory are taken prior to and also subsequent to the balance sheet or cut-off date.

Checking of a sufficient percentage of inventory is also a most important element. The auditor satisfies himself of the client's observ-

ance of inventory taking rules by personal observation during inventory taking, and by sufficient inquiry among those who participated in the planning and in the actual taking of the inventory.

If the client's own methods are unsatisfactory that matter is brought to the attention of responsible officers and correction insisted upon. In extreme cases the inventory must be retaken. I know of no case in which satisfactory changes could not be brought about if the matter were discussed prior to inventory taking.

Tact, persuasion, sometimes more forceful measures may be necessary, but in the long run the client does not succeed in persisting in his perversity.

Where the accountant cannot prevail, however, he has two alternatives, either to withdraw from the engagement or to qualify his certificate in such a way that the reader of it will be made fully aware of the situation. In extreme cases, as I have already said, there is no alternative but to withdraw.

Q. Now, in appraising the integrity and accuracy of inventory quantities, quality, and condition, is it your practice to ascertain and give weight to the nature of the stock-keeping, shipping, and receiving records, and methods?

A. As to quantities: Weight is given to the nature and the type of the shipping, receiving, and stock-keeping methods. The presence of an adequate system of perpetual inventory is decidedly significant. Effective internal check through segregation of functions is likewise extremely important.

As to quality and condition: The auditor should always secure a certificate from responsible officers and employees. Nevertheless, stock records do indicate slow-moving items which furnish the basis for further inquiry. This does not mean that on rare occasions the condition of the merchandise may not be appreciated by the auditor through mere observation and general as distinguished from technical knowledge.

Q. In your opinion, should an auditor be reasonably familiar with the general nature of the more important products manufactured or dealt in by the client?

A. I have assumed that by "reasonably" you mean sufficient in his judgment to know the processes and the controls which guide the auditor in a decision as to the type of testing, the extent thereof, and similar items. If that is so, I should say, in most instances, the familiarity should be as to the items mentioned and only generally as to the products.

The auditor may, because of experience gained otherwise than as an accountant or auditor, be familiar with the technical nature of the client's products, but such expertness is something aside and apart from his skill and training as an auditor.

Q. I wonder if you could expand just a little bit on the question of spot checking which you have referred to there; that is, checking by actual count or inspection. Is it your practice to make that?

A. Oh, yes. Spot checking has three phases: There is the spot checking which occurs if the auditor is present during the inventory taking. He actually rechecks inventory items, compares the inven-

tory list with the goods, makes his notes for his own work papers, and then compares the finished inventory sheets of the client with these field notes. That is one phase.

Another phase of spot checking is throughout the year when the auditor may check selected items against perpetual inventory records or similar records.

And the third phase is the checking of selected items in inventory against the client's inventory sheets, usually employed when the auditor was not present during inventory taking.

In such tests due weight must, of course, be given to interim purchases and sales. In many instances the third is the only type of spot testing that is available.

Q. When you say due weight, does that mean you would determine the physical quantity on hand, the date you go in, and then adjust back to see how nearly it would check with the quantities supposed to have been on hand at the cut-off date?

A. That is correct.

Q. Would you say that the auditor would have to be familiar enough with the products to be able to identify these things, or if not, how do you go about making your physical test?

A. It is really a clerical awareness as distinguished from a knowledge of the product itself. Merely on the basis of the record, which consists not only of the book entries and the documents, but the corresponding markings on the merchandise, whether in bins or in original containers, or otherwise.

Now, if by your question you mean whether the client could not substitute for what merchandise should be there, merchandise of different quality, without the auditor's being aware, granted sufficient collusion between necessary employees, that surely could be done with respect to any number of items.

Q. Do you believe that that possibility invalidates or decreases the use of a spot test of the type you mentioned; significantly decreases it?

A. It means absolutely if one seeks by spot testing to attain the utmost of human certainty, the goal will not be reached. It does not mean that the test has no value.

Q. Would you say, for example, that the auditor would be entitled to rely on going to the place where the records show such material to be stored and measuring or counting it and assuming that it is the type of goods which the record has described subject to such knowledge as you may have of the goods?

A. Because of the recent case, and you have asked me to differentiate as between before and after, we finished recently a physical count and a test check of a large distillery warehouse.

We noted very carefully the records of excise taxes, withdrawals, and accessions, the markings both on the containers as well as on the records, and record both in and out of the warehouse.

We did everything which justified us in accepting that the inventory presented by the client was correct, modified as we found it necessary to modify it in slight arithmetical fashion, but if you were to ask me whether the whisky in one large container was 7 years old as alleged,

or 6 years old, or 8 years old, although it showed so many gallons, or whether it might not have been alcohol and water in untested vats there instead of the material alleged to be there and which we feel humanly certain is there, I could not answer.

Q. Speaking generally, do you feel that in spite of these other difficulties you have outlined, that physical tests nevertheless have a great deal to recommend them and should be made by auditors?

A. Well, it is perfectly human to be empirical. They have worked in 99.876543 percent of all cases, more or less.

Q. Is it your practice to make any over-all tests of the reasonableness of the inventory quantities, say, by comparison with storage capacities, insurance payments, tax payments, normal or average consumption and production and similar tests of that nature, and trade statistics, and so forth?

A. We do employ quite generally the gross-profit percentage test, although we are fully cognizant of its limitations.

I know of no one who can honestly say that he makes a practice of comparing quantities reported in the inventory with the capacity of the warehouse.

We do try to detect disproportionately large items in the inventory not so much in search for fraud, but rather and primarily for the purpose of exercising judgment as to the fairness of the pricing.

This is on the theory that the inventory should be valued in relation to normal quantities employable by the client. A study of prior consumption and production may indicate reasonableness of inventory quantities. What I have already said about comparison with warehouse capacities likewise applies to the use of trade statistics of production, consumption, and imports.

When fraud is discovered, when the criminal is behind prison bars or under a tombstone, post mortem wizards may puff up in self delusion and ascribe to themselves virtues which they and I and you know they do not possess and present charts to prove that alertness on the part of a predecessor auditor would have discovered the irregularities of a type brought to light by those who undertook an investigation after the exposure.

I have two illustrations of that, one from a hop case and one from a match case, if you want them in the record.

Q. It is at your discretion.

A. Many years ago I was engaged by people who were interested in establishing that the defalcation of a detected criminal, based on discounting of false invoices representing sales of imported hops and forged shipping documents, should have been known to the criminal's principals.

The issue was as to the relative innocence of two innocent victims.

In the attempt to establish the thesis, I showed that the reported sales were impossible in terms of world production of the product, in terms of the annual consumption by American consumers, and in terms of the impossibility of having actually made the reported sales within the time listed in view of the territories alleged to have been traversed personally by the embezzler.

I was undoubtedly amateurishly proud of my achievement, but frankness invites the observation that no independent accountant

before that time or since would ever have planned during the course of the normal professional engagement to make my type of survey and study.

And then there is the *Kreuger Match* case illustration.

One of the many issues arising in Ivar Kreuger's activities was alleged misfeasance and nonfeasance of the American directors of the International Match Co. They were sued for many millions of dollars. My firm was appointed by the court as accountant to the trustee. In connection with the suit, our investigation developed that despite the 1929 crisis and despite the fact that the match company's income was to the extent of about 98 percent from foreign countries in the worst depths of the depression, Kreuger managed to earn for the American company almost unfluctuating net income of \$20,000,000 per annum. The trustees' attorneys made much of this impossible situation which failed to arouse the directors or the former accountant's suspicions.

We also discovered that Kreuger had arranged for custodianship of some \$50,000,000 of German Reich bonds belonging to us in his controlled German bank, from which he could remove them at will as he later actually did. We were able to show that the semiannual coupons were payable in New York so that there was no possible business reason on the part of the directors to permit this custodianship to have been created or to persist.

We found that the bank to which the custody was entrusted was capitalized at about \$3,000,000. The attorneys claimed that this proved gross carelessness on the part of the directors. I am not arguing the point, of course.

And, finally, it was also shown that a \$17,000,000 advance to N. V. F. M. Garanta, at 24 percent per annum interest, was to a Kreuger corporation without assets, without transactions, without records, with no office. The attorneys found in the directors' failure to discover these and other facts dereliction on their part.

Our development of the facts was comparatively easy after the suicide, suspicion, and revelation.

It is probably beside the point at this hearing to ask which of these items would have been revealed by the procedure suggested in the bulletin or by the reasonable equivalent thereof, although two of these items, in my opinion, might have been brought to light by many accountants whom I know, including my own office.

Q. In the early part of your answer you referred to the gross-profits test. In your opinion, should that test be made on the basis of departmentalized figures, or on aggregate over-all figures?

A. I have already indicated its limited application. If you can departmentalize the test, you limit the range of error, and therefore it is preferable not to have an over-all test for the entire merchandise, but to restrict it to groups of items.

Q. What purposes does that test serve; what does it do?

A. Its employment is to some extent historical. It is used despite its limited application to test the apparent or gross correctness of the valuation of the inventory. It has a collateral use, however, in revealing abnormal trends which may result in supplemental investigation.

For example, gross-profits margin may be found to differ much from that of the preceding period and would then, as I say, invite

investigation. If the margin decreased, that might possibly indicate one or more of the following:

1. That purchases have been inflated;
2. That sales have not been entered;
3. That the opening inventory had been valued excessively; and
4. The closing inventory had been undervalued, and the reverse would be true if the margin went the other way.

Investigation might reveal that the change had been brought about by a shift in the treatment of overhead, as, for example, where expenditures formerly treated as manufacturing overhead, direct or indirect cost of the product, were now treated as selling expense, for example.

One of my partners brought to my attention the fact that a case illustrating what I have just said is on the desk now for investigation.

Q. What evidence do you customarily rely upon to verify the quantity of merchandise which is held in independent warehouses or vendors' warehouses, that is, places not under the control of the client? Do you investigate financial responsibility in those cases?

A. To try to locate misappropriation of merchandise?

Q. Yes.

A. Merchandise in outside warehouses is almost invariably verified by direct confirmation. The procedure is no different whether the outside warehouse is an independent establishment or owned by or under the control of the vendor.

Commencing about 3 weeks or so ago, there may be personal inspection and probably will be for some time. It is not the practice to attempt to ascertain the financial responsibility of warehousemen. Confirmation from the vendor could not possibly disclose whether he had misappropriated the client's merchandise.

If title to such merchandise had passed to the client, it is quite probable that some further inquiry would be made by the auditor, but I doubt that he would go beyond bringing the matter to the attention of a responsible officer of the client upon whom he would rely for pursuing the matter further.

Q. When you referred to not making any investigation of financial responsibility of warehousemen, did you include there a warehouseman who is also a vendor?

A. Well, we don't usually try to ascertain the financial responsibility of a person from whom we buy. Now, if such a person holds merchandise which belongs to us, for which we pay—if, for example, a dyeing or converting mill which makes shipments on requisitions issued by us, if the flow of transactions indicates that our merchandise is being properly handled, it has certainly not been customary to inquire about the financial responsibility. That is one of the things, too, that may be done from now on.

Q. Are there any tests that you make as to quantity, quality, and condition of inventory which we have not discussed?

A. I believe I have discussed them all.

Q. Now, looking to the future, Mr. Klein, what procedures do you think auditors should use or employ in verifying the quantity, quality, and condition of inventories?

A. I believe that in the immediate future there may be manifest, as to some extent there already is, and the latest indication of which

appeared in the morning's press in connection with Schenley's, a desire on the part of the client to have the auditors participate more extensively in the preparation of inventory taking, the presence during inventory taking, tests of inventory quantities, and perhaps reliance on certificates of engineers called in especially for inventory taking purposes.

By the same token I believe independent accountants may be called upon to state what they did as well as what they did not do in connection with the inventory taking.

I notice in the recently published statements a reluctance on the part of some accountants to do that but I prophesy that they will soon come on the bandwagon.

I am disinclined to state that the present tendency will result in a permanent change and I do so on the basis of my own experience with what someone has called the 1920-21 inventory crisis and perhaps I will tell you about that in a moment.

Q. Would you like to do that now?

A. Two cases are in point: In both, the inventory consisted of imported goat skins, mostly from China. The agreement between the importers and their agents led me to believe that title to the goat skins passed to the client immediately upon the acquisition of the skins by the agent from the Chinese farmers in the remote interior.

At December 31, 1920, the books did not reflect these purchases nor their in-transit status, nor the fact that goods acquired at \$20 or so a dozen were then worth not more than \$5 or \$6 a dozen.

Despite certification of the 1920 statement by two very well known independent accounting firms of highest repute, I established:

1. That title had passed to the clients on December 31, 1920;
2. That therefore these goods should have been included in their inventories at depression values;
3. That full purchase liability should have been disclosed; and
4. That the resulting loss should have been reflected both in the balance sheet and the operating statement.

The result of being able to establish these points about title resulted, so far as one of these two clients was concerned, in the abatement of Federal taxes amounting to \$750,000 and cash recovery of slightly more than that amount.

The other client recovered a few thousand dollars under \$3,000,000.

Despite the importance of the question of title in connection with the ownership of personal property demonstrated by those cases to which full publicity was given, which came to the ken of many accountants, I doubt that realization of the importance permanently influenced the scope of the accountant's examination of inventory so far as the title question is concerned.

I cite those examples as indicative of the reasons why I hesitate to prophesy permanent changes as the result of even a very dramatic incident.

Q. Would you say that you think it would be desirable in general to make the type of physical tests as to quantity which you have described as part of your own procedure, spot testing of one sort or another?

A. My answer is that we try to do that in almost every case.

Q. And do you think that would be generally desirable as a recognized audit procedure?

A. Yes; with one word of caution. I think S. E. C. should cooperate with all other suitable agencies—governmental and private—to avoid creation of the belief that extended participation by accountants in inventory activities will guarantee that all inventories are correctly stated as to quantity, quality, condition, and value. Harm will inevitably result, I fear, if investors, credit grantors, and others are lulled into a sense of security not warranted by actualities.

S. E. C. will, I am confident, be realistic in its approach to the subject.

E. OTHER BALANCE SHEET ITEMS

Q. I would like to turn now to some of the other items on the balance sheet. Referring first to item 4 on page 21, what procedures do you follow to determine that amounts capitalized as additions to plant represent real additions or improvements?

Do you inspect the plant physically in this connection, or what?

A. The plant is not inspected for the purpose in question. Requisitions from the plant manager, superintendent, or engineer are reviewed and explanations are requested from those familiar with the items; contracts, invoices, engineers', and/or architects' certificates are scrutinized.

In connection with such inquiry the machinery, equipment, or work involved may be pointed out to the auditor. There is comparatively little difficulty, if the cost is substantial, in determining whether the charge should be made, on the one hand to a nominal or expense account or on the other hand to an asset account.

Q. Referring now to the bottom of page 34 in the bulletin, what procedure do you follow to ascertain that plant units have been abandoned and, therefore, should be removed from the asset account?

A. Physical inspection is not attempted as a part of routine procedure. Much has been said recently about inadequate provision for plant depreciation and obsolescence. Dr. Paul P. Gourrich, the eminent economist, who has made such notable contributions to the enlightened thinking of S. E. C., has long pointed out this fact. His views were rather dramatically supported recently in the published statement of United States Steel Corporation, which, at the end of 1935, adjusted its reserves to the extent of over \$80,000,000 because of apparently inadequate charges during earlier periods. Where there is a plant ledger, and we advocate its use in applicable situations, completely depreciated items are readily ascertained. Whether actual abandonment has occurred and whether the occurrence has been reflected in the records, is usually revealed through inquiry. Sometimes, changes in pay-roll and expense accounts, diminution in type and volume of production furnish clues. A radical drop in insurance coverage may indicate abandonment.

We show permanent abandonment of a material part of the plant as a separate item on the balance sheet.

Where the matter is of real importance, the accountant's investigation would be greatly helped by plant appraisals.

Q. Now, referring to the question of insurance charges, what steps do you take to establish the amount that should be charged to insur-

ance expense in a given year as opposed to deferring it to subsequent years?

A. The question, it appears to me, does not seem to deal with a really important item. Unexpired prepaid insurance premiums are determined by consideration of the amount of the premiums paid, the date of payment, and period of coverage.

For this purpose the client's records are examined and statements are sometimes received from insurance brokers as well as from insurance companies. No great reliance can be placed on the relationship between the amount of coverage and the value of the asset insured; nevertheless, this relationship is not entirely overlooked.

The insurance policies may reflect, to a limited extent, title to property and liens thereon, that is, clouds on title, hypothecation, et cetera.

Q. Would it be customary to examine the insurance policies?

A. Principally, for the purpose of ascertaining questions of titles and liens, to see to whom the insurance runs. Policies are frequently examined but the calculation of unexpired insurance is most frequently obtained from calculations made by the client's own staff or furnished by the brokers and these are tested rather than that the policies are thoroughly examined.

Q. Now, looking at page 24, item 2-C, it is suggested that a close examination be made of creditors' monthly statements covering large balances. What do you consider to be an adequate test in that respect?

A. First of all, such examination is not normally undertaken as a part of the ordinary engagement, except in connection with accounts with respect to which controversy may exist, in which event the correspondence between the parties is also studied. The reason is this: The examination may begin at any time, normally from 3 to 6 weeks after the balance sheet date. If reliance is placed on the retained monthly statements, especially those which are in agreement with the books, considerable opportunity has been furnished for manipulation. That is quite evident.

If we feel that certain statements ought to be used, we would obtain them as a result of direct correspondence with creditors.

Q. Now, looking at page 8 in the last paragraph, there is a statement, quoting:

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

What is the significance of this requirement?

A. The reference appears to be to one of the essential and routine elements in effective internal check and control.

The person who makes disbursements should not be the person who approves the disbursements and neither of them should be the person who makes the record or keeps the books.

Q. Turn for a moment to taxes. Do you expect your staff to have a general knowledge of all types of taxes impinging upon business, both domestic and foreign?

A. The members of our auditing staff, especially the seniors, are expected to have a good working knowledge of Federal and State taxes. Two partners and I are, I believe, reasonably familiar with other types of taxes as well. We do not, however, attempt to pose as experts with

respect to foreign taxes and special local taxes of foreign jurisdiction, although during the course of the audit we become reasonably familiar with taxes which we had not theretofore come into contact with.

Q. Is the question of taxes one of the points which you would take up in the course of the audit and give special attention to?

A. Increasingly so, because unpaid taxes, threatened additional assessments, may constitute a very material element in the preparation of the statements.

Q. Now, turning for a moment to contingent liabilities, which procedures do you follow to determine the existence and amount as contingent liabilities? What responsibility do you feel you assume in that connection?

A. The auditor becomes aware of all contingent liabilities with respect to which there are any records. Such records include reference to discounted commercial paper, bank confirmations, minutes, records as to guarantees of subsidiary and affiliated units, records relating to litigation. In some instances, disbursements indicate payments to attorneys or through attorneys, which may furnish the necessary clue.

With respect to litigation expenses and contingencies, a statement is obtained from counsel.

Responsible officers are requested to furnish a certificate that there are no contingent liabilities except those which are listed in the certificate. The accountant can assume no responsibility for failure to refer to contingent liabilities which do not come to his notice as a result of the procedure which I have already outlined; it is also not his responsibility to attempt to forecast or prophesy the extent of actual liability which will stem out of contingencies.

It is sufficient that the fact of the contingency, if it appears to be material and substantial, is brought to the attention of the reader of the report.

If reserves are ample, that suffices for statement purposes and such reserves need not necessarily indicate their nature because that sometimes invites a lawsuit which is not even threatened.

Q. First, you say all contingent liabilities which are reflected in the record. You mean the records which the accountant examines, I take it, in the ordinary course of his audit?

A. Which he did or should have.

Q. Or should have?

A. Yes. Not in some peculiar type of record, such as in general correspondence. Regarding that, I would say it is not the duty of the accountant to go through all correspondence files and files of employees on a sort of fishing expedition to see what he might come across. That's exactly what is done in bankruptcies, or after a suicide of a criminal, and that's why the results of the latter type of examination appear to the uninformed to be so startling.

Q. Do you think that the auditor should look over or read important contracts of which copies are in the files of the client?

A. I meant to refer to the fact that contracts furnish a clue to contingencies and auditors should read important contracts and all long-term contracts; even commitments for merchandise should be asked for and scrutinized.

Q. Is it customary for you to consult counsel in connection with contracts of which you have any doubt?

A. I happen to be a lawyer and so are several of my partners, so we go through the foolish motions of acting as our own counsel.

Q. One further question at this point. Is it customary for you to examine all types of minutes in this connection; that is, not only the corporate minutes of stockholders' meetings but also those of boards of directors and special operating committees; finance committees?

A. All of those minutes are examined and should be examined. All minutes of which we know the existence of should be asked for and studied.

Q. Thank you.

Mr. WERNTZ. May we have a few minutes recess?

The EXAMINER. We will take a few minutes recess.

(Whereupon a short recess was taken.)

AFTER RECESS

F. PROFIT AND LOSS ITEMS

Q. (By Mr. WERNTZ.) Now, Mr. Klein, may we turn for a moment to the profit and loss statement. Item 1 on page 30 suggests that the accountant obtain a working profit and loss statement, or prepare one in as much detail as is readily available. For this purpose to what extent would you, or do you, obtain and utilize financial statements and analyses which the client has prepared?

A. Such analyses and statements are always requested and are found useful. They are used as something for the independent accountant to check against and they might be said to constitute a possible starting point of the examination insofar as the preparation of the auditor's own statements are concerned.

Q. And I think you said that you specifically require any statements that the client may have prepared?

A. We ask for them.

Q. What is the purpose of obtaining budgets, previous annual statements, and monthly statements as outlined in there?

A. Oh, the documents referred to are informative and may sometimes furnish clues for specific inquiry and investigation. Any significant change is the subject matter of express inquiry and/or examination. Failure for the definite, definitive figures to meet the prognostication implicit in the "Budget" is sometimes made a subject matter of inquiry.

Q. Do you attempt to establish to your own satisfaction a reason for those differences?

A. We ask about them. Sometimes the answer given satisfies us at once; sometimes the subject is pursued at greater length.

Q. In item 3 under "Sales and Cost of Sales" is outlined a procedure for testing allowances to customers for returned merchandise, claims, and rebates.

What is the purpose underlying such a test and is it customary for you to make it?

A. The analysis may be very important because such credits are sometimes utilized to cover up defalcations. I should say that such analysis is invariably made unless the aggregate total of the allowances is insignificant.

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 follow to verify that classification?

A. The answer to this question depends on the purpose of the examination. If the report contemplates a very condensed income and operating statement, general tests and scrutiny would suffice.

The tests would consist of a comparison between the balance sheet of the prior period and the final balance sheet, giving due weight to plus and minus items in the surplus account, and that over-all difference would test the correctness of the net profit or net loss.

On the other hand, if a comparatively detailed statement of income and profit and loss is to be included in the independent accountant's report, more extensive tests are necessary.

My firm does not attempt to check all charges and credits to expense and income accounts; tests are made and, as I have already stated, the extent of such tests depends on circumstances.

In general, the classification should be such as fairly to present the facts.

Q. To expand that just a little, would you say that you make, or take, samples of the charges to various expense accounts and then scrutinize the remaining periods for unusual or large items?

A. Well, we scrutinize those larger important items. I do not think, however, that we take the same period as we would for testing receivables, sales, or disbursements.

Q. Would you investigate any expense accounts which had increased materially over a previous period or decreased materially, to satisfy yourself whether the same principles had been applied in making charges to it?

A. One of the work sheets we use invariably sets up these expense items in comparative form, sometimes for the current year and 2 prior years in terms of ratios to total expenses, so that significant changes in the trend, as you have indicated, must inevitably come to the attention of the supervisor or other reviewer.

Q. Would you review the classification which the client has adopted in its accounts and attempt to determine whether the people responsible for determining the accounts to be charged in particular instances understood the distinctions between the various accounts?

For example, as to whether depreciation on trucks was to go into selling expense or to general depreciation account and things of that type?

A. I am sure that we wouldn't deliberately set out to determine that fact, but in the course of our examination, if we came across bookkeeping errors, the inquiry would undoubtedly lead to the discovery that there was, if there was, lack of proper bookkeeping training and understanding.

Q. Would you review the classification of accounts followed by the client to see whether the distinctions—the instructions were correct in comparison with the account title?

A. Only generally. In the years when we felt that we were responsible for the precise language of the statement, we would employ our own nomenclature.

Now, it makes little difference to us, for example, whether a client captions the classification "Selling Expenses" or "Distribution Expenses."

Q. Surely—

A. (Continuing.) But whether the distinction between the major classifications is recognized and adhered to is a subject matter for tests.

Now, that test may become more extensive if we find that there is lack of understanding.

V. REVIEW OF THE ENGAGEMENT

Q. Now, turning away from the details of the audit program and looking to the general review and preparation and financial statements, in your practice who is responsible for drawing together the results of the detailed audit and drafting or casting the preliminary statements?

A. The supervising senior in charge drafts the report which embodies the results of the examination.

The draft includes the preparation of financial statements, which are to be incorporated in the report; invariably the partner reviews the senior's work and, therefore, the precise answer is that the ultimate responsibility rests with the supervising partner.

Q. Is it customary to have the statements and working papers reviewed by anyone other than the person actually performing the work, or supervising the audit?

A. Yes; by a partner who may be the active supervising partner, or another.

Q. What is the purpose of such a review? What does it intend to reveal or check up on?

A. Generally, the purpose of the review is to make sure that the prescribed examination steps have been taken and that they are adequate; that the financial and operating statements prepared are properly supported in the working papers; that the suggested comments are in order and proper; and that no essential comments have been omitted; and to make such modifications and changes as a study of the working papers and the conference with the supervising senior, and sometimes with some of his assistants who are on the engagement, indicate to be in order.

Q. Now, I wonder if you would describe in some detail the actual steps followed in your reviewing program, indicating who performs them and what he does. That is, just draw together your whole system of review, if you will.

A. As I have already stated, a partner is primarily responsible. Whenever possible, the partner reviews the documents by himself and makes notes of the items with respect to which he wishes to confer with the supervisor or others.

In this preliminary review, the partner may have recourse to the work sheets and reports of prior examinations. During this preparation the partner assures himself, in a general way, that the prescribed program has been followed. In his later conference, the partner

brings up the questions with respect to which he has made notes, and such others which are desirable or necessary.

This program is the ideal one.

The degree of adherence to the ideal program may vary with the importance of the engagement.

In general the partner assures himself of what was done, its adequacy, the general correctness of the financial and operating statements, on the basis of the supporting figures, and their reasonableness; the propriety of the suggested notes and comments and whether or not others are needed.

Q. Now, there are one or two questions I would like to ask you there. First, the person who makes the preliminary draft of the statements, would he examine in detail the working papers of the individual parts of the audit program; that is, the schedules and things?

A. He has done so continuously during the program of the audit. As one section of the work is completed, it is brought to him. As a matter of fact, before any such work for supervision is available, he may actually do some of the auditing himself but when the papers begin to flow to him he examines them immediately and questions the maker of them and then only later does he draw them together.

Q. Now, is there anyone other than this senior who checks the tie-in between the working papers and the financial statements in detail, as to arithmetical accuracy and so forth?

A. Yes; there are other steps. Reports are checked in detail from the draft financial and operating statements back to the supporting data in the work sheets. Such checking is by an experienced senior accountant. If conditions make it impossible to provide for the checking described, the reviewing partner does more detailed checking than otherwise. After the report is released by the partner, it goes to our typing office, which is in charge of a Canadian chartered accountant. As a part of her duties, in conjunction with the reading of the report, she and an assistant or two check the statements for arithmetical accuracy and as to agreement between schedules and statements. This latter step is by way of clerical check.

Q. With a little more than merely clerical, that is, the person in charge is an accountant, you might say. Is that correct?

A. I think that is so by and large correct, but what I am trying to emphasize is that, aside from the second senior's check, the partner does not review the supervising senior's work to such an extent as to constitute a second check of what that supervisor has done.

Q. You say a second check. What would be the first check?

A. He, himself—let me approach it this way: The statements are self-checking to some extent. There is a relationship, as you well know, between the profit and loss statement and the balance sheet so there is an over-all test. His schedules must agree with the controlling or other general and composite accounts.

Q. And who is that who would check that?

A. The supervisor does that. As a matter of fact, when the assistant, junior, or semisenior, brings to the supervisor, say, schedule B-2, the supervisor often knows before that schedule comes to him what the total thereof should be, from general ledger analysis and survey, so there is that test as you go along in the work.

If the supervisor should blunder in some double way that may not be detected.

Q. Would you say this, then, that looking at your process of review, as a whole, there is certain work done by the supervisor which is not checked in detail by anyone else?

A. That's correct.

Q. But there is a test check by the partner which may extend to the working papers in particular instances?

A. I must concede that in this process of checking a point is reached beyond which we do not go.

VI. THE REPORT OR CERTIFICATE

Q. Yes. Now, turning to the form of accountants' report or certificate, what class of persons in your firm is authorized to sign a certificate?

A. Only a partner.

Q. And I take it it would be drafted by the senior and reviewed by the partner?

A. As I have indicated.

Q. Is it your practice to use a certificate along the lines of that set forth on page 41 as indicating an examination comparable to what is described in the bulletin?

A. We did for quite a while. About a year ago we began to modify it, primarily by stating expressly that the examination, the extent of it, and the tests were "in the manner and to the extent that we deemed adequate in view of the system of internal control."

And the explanation of that change is found in the fact that I had come gradually to the conclusion that bankers and other credit grantors and investors were somewhat uncertain as to whether the language of the certificate meant what was claimed for it or whether weasel words were being used.

I came to the conclusion because I made the decision in my firm that if these words meant what the quotation I have just given you meant, we might as well use the quotation and that is what we are now doing.

Q. And if they didn't mean that?

A. If they didn't mean that, they shouldn't mean that, I suppose.

Q. That's what I had in mind. What do you understand to be the function of an accountant's report or certificate?

A. To indicate the scope of his examination and, if unqualified, to express a professional opinion that the statement covered by the certificate—that the statements covered by the certificate are believed to be substantially correct.

Let me add, as I think this is an answer to part of your question: so far as the comprehension and understanding of most readers of the published reports are concerned, too much language and too many figures are given.

I do not advocate less essential information, far from it. I do say that for the average reader, not the banker, the analyst, the brilliant attorney representing S. E. C. and the trial examiner, the statement—brief statement that each share has earned so much during the current year compared with so much during the prior

year and a similar statement that behind each share of stock there is so much in net assets this year, and current net assets this year, as compared with the year before, is all, in my opinion, that the average lay reader can hope to obtain from the published statement, and in many instances he doesn't obtain that.

I should say that what I have described as the objective should be given to him in that form in preference to the complete statement, but so far as I am concerned he may as well have both.

Q. Is that for all types of businesses or do you limit it to particular types such as investment trusts?

A. I would not differentiate at the moment any type of business in which there is an interest represented by a lay investor, an average investor, one of the general public.

Q. When you say amount of assets behind each asset—

A. (Interposing.) I said net assets.

Q. Does that have any weaknesses inasmuch as in industrials, at least, there would be large amounts of fixed assets not on the present value basis?

A. I said net assets total and net current assets.

Q. I am thinking here of the total.

A. Assuming that that were a weakness, and a difficulty, the fact remains that that weakness and that difficulty are multiplied many times over when you give the total of the assets and expect, if you do expect, that the member of the laity, such as I have described, is to make his own calculations.

Q. Perhaps it would be desirable to remove the dollar figure from those assets, which introduces another difficulty, as has been done in some cases.

Is it your understanding, Dr. Klein, that the second sentence of this form of certificate is intended to be a reasonably comprehensive statement of the scope of the examination?

A. That sentence is intended as a very general summary statement of the scope of the examination. It would be reasonable for the readers to assume that the scope of the examination was, in the accountant's opinion, sufficient. It would not be unfair for the reader to assume that the scope was, by and large, as extensive as that suggested in the bulletin.

Q. And I believe you indicated that you had modified that sentence to some extent in your own certificates in recent years?

A. Yes; only during the past year, or about a year.

Q. Do you believe that any material omissions from the program indicated in the bulletin, taking that as a standard for the moment, should be indicated in the certificate and I have reference here not to omissions which are made because they are inapplicable but for other reasons?

A. I believe that if the auditor has found it impossible for any reason to make the type of examination which he deems to be necessary for the purposes of the report, that such omissions should be clearly referred to in the certificate.

If the omission has been sufficiently vital, the auditor will not issue a certificate, and if necessary even retire.

Now, that step of retirement, and failure to issue a certificate, is both professionally sound and practically wise.

I can illustrate that very readily: Recently a famous neurologist whose name appeared in the press 2 weeks ago issued a prescription for morphine for a patient which the druggist refused to fill.

At the insistence of the family the druggist telephoned to the doctor and the doctor's reaction you may well imagine. The druggist's job, according to the physician, was to fill the prescription. But the druggist would be blessed if he would for a dollar sale, which might net him 25 cents profit, run the risk of spending a day or more at a coroner's inquest and the embarrassment that would go with it, because the prescribed dosage according to the United States Pharmacopeia was a lethal dosage.

Now, when an accountant comes across a situation which bristles with danger, the more experienced he is the more readily he will run away from it.

Q. What would be your thought as to this: If stockholders or directors select auditors, and a situation of that type is found, would the auditor have any duty to bring his findings to the stockholders since he had been elected by them?

A. Yes; if he were elected by the stockholders or if he were engaged by a bank or any outsider to make an investigation and he found that he were balked and necessary cooperation were not forthcoming, he would notify those on whose behalf he was acting.

Q. In other words, he would make something which was not an accountant's report but which is completely different from a certificate such as is contemplated here?

A. That would depend on how far he had progressed.

Q. Naturally.

A. Yes; he would report on what he had done if it were reportable.

Q. I believe you said that you thought from the second sentence of this certificate that the investor readers were entitled to believe that an examination in accordance with this audit had been made and then when you were responding to one of the more recent questions, you said any step which the auditor felt was necessary and was not made should be given notice of in the certificate; is there any inconsistency there? Or, is it left to the auditor to judge whether one of the steps is necessary, or should the investor be told if any step which this bulletin contemplates, for example, is omitted, irrespective of the auditor's thought on it, on the matter?

A. First, as I have already clearly indicated, or surely tried to, any reference in the certificate would be, not because steps suggested in the bulletin, which must not, I insist, be regarded as sacrosanct, had not been taken solely because, in the opinion of the independent accountant, the reader should be informed that there has been some material restriction on the necessary scope of the examination or that for some other reason all that the accountant believes should have been done was not done.

The certificate would, of course, also indicate differences of opinion between the accountant and the client as to the treatment of items.

Q. Is it customary for you to reduce your audit engagements to the form of a written document?

A. Between the client and ourselves?

Q. Yes.

A. No; we make a memorandum for ourselves. With respect to clients of long standing, where there is no material change, nothing

is said. With respect to new clients, we sometimes write in rather great detail exactly what we intend to do and what we intend to cover.

Q. Those are internal memoranda?

A. No; I am talking about sometimes writing to a new client, but there is no invariable custom. Sometimes the audit arrangement is made over the telephone.

Q. Do you reduce your plan to a written form for your own files—that is, to give notice to your own staff?

A. Yes; in every case the printed audit program which we use may well be modified to meet the felt needs of the new engagement.

I doubt if on any audit we use the program as is without some addition or subtraction or other modification.

Q. Now, as to any steps which you are not going to make by virtue of agreement with the client, which might be for purposes of this special engagement; for example, if any of those steps were not taken in a general engagement for the purpose of certifying, the same criteria, I take it, will be applicable as to whether you should make mention of them in your certificate; that is, whether it limited the scope of your audit in your opinion as an accountant to some extent that you had to qualify?

A. If we felt that a qualification was desirable, it would be incorporated.

Q. Or going the full way, if it were too limited you would not give a certificate, and then you would have a special investigation, so to speak?

A. Yes; you would make a report in which you stated many things.

Q. Do you determine the necessity of particular steps before you go into the engagement or before you sign the certificate or during the course of the audit?

A. Well, there is this initial conception of what we think we would find and what we think we should do; as I stated at this hearing 2 or 3 weeks ago—for it seems I have been here that long—that program, that predetermined program, is modified as the exigencies of the case demand.

It is quite possible, though I do not recall a case now, that the partner at the time of reviewing the work would decide that something that should have been done had not been done in the, let us say, wrongful exercise of discretion by the supervisor. We would not condone that error. It might be very embarrassing to have to go back to the client, but I am sure we would.

Q. Would that hold true even though you may have agreed with the client in advance that this particular step should not be done, not to take any step?

A. Let me be specific. On the representation of the client that there was a well-tested-out and satisfactory working system of internal check and control and that specifically stock records were well handled as described by the client, and our examination revealed that while the system had been established it was not observed, that would change the situation so materially that we would try to convince our client there had been no proper meeting of the minds.

Q. That is what I wanted to bring out. Now, looking again at this certificate on page 41: What language in there indicates that there has been no material change either in accounting principles followed

or in the manner of their application as compared with the preceding period as is called for by No. 5 on page 41?

A. That portion of the opinion paragraph which reads:

In accordance with accepted principles of accounting consistently maintained by * * *.

There are many probably who believe that the reference to "during the year under review" is misleading because the consistency should relate to at least the immediately preceding period as well as to the period under review, and if there is lack of such consistency, express reference thereto must be incorporated in the certificate, in my opinion.

Q. Would it, do you think, be desirable to change or expand that language to point out clearly that there is a consistency with the preceding period?

A. I think that condensation rather than expansion would accomplish the purpose. "Consistently applied" would mean, in my opinion at least, as between this year and the prior year and throughout the 2 years.

Q. Just by dropping the phrase, "during the year under review" would accomplish that?

A. I believe that the expression I have used is meant by many people to cover both periods.

Q. Looking at the introduction to the accountant's certificate as set forth on the bottom of page 40, it appears that matter might appear in the accountant's report or statements for the purpose of being merely informative or to state limitations on the accountant's work or to indicate dissent from particular practices of the company.

How in your practice do you distinguish between those three types of language? Do you have any procedure or language?

A. I regard this as one of the really weak spots, from the point of view of expression, in the bulletin. The sense should be clearly indicated in the certificate.

Q. In what particular part of the certificate?

A. This also applies to such limitations on the scope of the examination as, in the opinion of the accountant, should be brought to the attention of the reader.

"Merely informative" material should preferably appear parenthetically in the statements or as notes appended thereto. However, I would not stress the situs of the matter referred to. The real important factor is that somewhere in unambiguous language, easily seen, the required notation appears.

Q. Let us take an illustration. Take this common one that inventories have been certified as to quantity, quality, and condition by officials. If that appears in the statements themselves or on the face of the statement, does that carry any different meaning to you than if it appears, let us say, in the opinion paragraph of the certificate with an "except" in front of it?

A. To make it perfectly clear, let me say that that expression is, I believe, informative rather than a limitation. My firm indicates exactly in what respect the tests have been limited—sometimes by affirmatively stating exactly what we did. We say we have supervised the taking of inventory; we have merely checked its arithmetical accuracy; we have merely tested unit prices; we have merely

tested quantities, what percentage we have tested, things of that sort, where we feel that such statement is material.

Q. Is it customary, do you know, to refer to other types of certificates received from officials in connection with the statement, such as some of those you mentioned, on contingent liabilities?

A. I have seen that done. Sometimes we have employed such statements, explanations. I am getting to believe that if the matter is merely informative and if there isn't a suspicion on the part of the accountant that something is wrong in the state of Denmark, there is no more reason to refer to such a source of information than to numerous other sources, and I also have a feeling that when something of that sort is incorporated it is intended as a red flag, let us say, with the proper connotation, a pink flag, to the readers, and if the notation is necessary, let us be done with it and say it forcefully and unmistakably.

Q. Now, one further thing, in the opinion paragraph of that certificate appears the language: "Based on our examination." Do you feel that that qualifies your opinion in any way, that general phrase?

A. I think that is entirely linguistic. The thing there ties onto what is done before instead of making the opinion paragraph too abrupt and brusque. Based on what goes before, "we opine."

Q. You do not intend it as a qualification of your opinion, I take it?

A. No; I think that if those words were omitted the significance would not be different.

VII. GENERAL SUGGESTIONS AND COMMENTS

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

A. To respond to this question it seems to me that emphasis should be placed upon the varying functions of the independent accountant: his services in connection with taxes, his services by way of system installation, criticism and revision of systems, and in various consultative capacities. In these fields no public interest is involved and there are undoubtedly sound and convincing reasons, economy, familiarity, confidential relationship, for continuance of the accountant in the engagement.

Now, a few words as to the service which consists of rendering a report which will be read and relied upon by others than management, for example, by stockholders, prospective investors, credit grantors.

It is a salutary rule which causes a judge to disqualify himself in a case where friends or relatives are party litigants. Independence connotes freedom from entangling alliances, of such entanglements as are associated with friendship on or off the golf course, blood relationship, or financial stake. Even in the relationship between the physician and his patient, when the matter is important we insist upon a certificate or statement from independent physicians.

I believe it is a tribute to the fundamental honesty and integrity of the C. P. A. that despite the closeness of contact and intimacy of relationship between him and his client which sometimes exist, his reports are nevertheless objective and impartial.

There are instances, however, where a victim cannot be blamed for suspecting that the type of relationship to which I have referred may have been a contributing cause in the issuance or utterance of a disingenuous statement or certificate. Unfortunately, there are in the files of S. E. C. a very few samples of such statements and certificates issued by independent accountants who enjoy the highest repute.

Where the public interest is substantial and where ownership relies to a great extent on nonownership management, all theoretical approaches—and surely a priori reasoning—indicate that, despite inevitably increased costs, rotation should be favored of accountants who certify to annual statements.

If there is such rotation it should not be alternation between two accounting firms, but the rotation should be radical and complete.

Tentatively it is suggested that consideration should be given to the wisdom of providing that such accountants should serve for not more than 3 consecutive years and for not more than 3 years during any 10-year period.

Q. Is it customary, Mr. Klein, for a representative of your firm to appear at directors' meetings at which the audited statements are to be presented? Do you have any opinions on the desirability of such a practice?

A. Only on relatively rare occasions. There is much to be said in favor of the practice, but accountants who appear must be prepared to be brutally frank; stockholders with one share of stock have a way of asking questions, and the understanding must be that the accountants are free to respond to all questions without any mental reservation.

If such appearance becomes customary, the increased burden on, and the responsibility of, the accountant would be greatly increased.

Q. How about directors' meetings? You mentioned the stockholders' meetings, especially.

A. I meant to include directors' meetings, except that in such cases the admonition about the necessity of speaking freely would be quite gratuitous.

Q. And also your warning as to the single share owner of stock, asking embarrassing questions?

A. Would, of course, not apply.

Q. Would you think that the auditor should have the right to speak on his own initiative as well as to respond to inquiries addressed to him?

A. Theoretical considerations would cause me to answer in the affirmative, but there is no such thing, practically, as a privilege without a corresponding obligation, and if the accountant were put in the position of having to use discretion as to whether to volunteer to speak or to remain silent, I believe that might prove to be quite an intolerable burden.

Q. Is it the practice of your firm to send copies of your reports to the directors in advance of the meeting at which the statements are to be considered?

A. Not usually. Sometimes arrangements to do so are made.

It would undoubtedly be well for directors to be familiar with the contents of the auditor's report prior to its presentation and consideration at the board meeting. One partner admonished me to be sure

to say that it is all we can do now to get the report out in time for presentation at the directors' meeting.

Q. Do you prepare enough copies to be sent to someone in the company so that all the directors may have a copy of the report if they wish it?

A. That depends on the arrangement. In some cases sufficient copies are provided for by arrangement. If nothing is said we send out the usual number which I believe to be three, perhaps more.

Q. Do you know in those cases whether the company reproduces the report so that all directors may have access to it individually?

A. I would not know that.

Q. Do you think that it would be desirable for the auditor to send a long-form or a short-form report to the directors if this general suggestion were adopted?

A. I am very clear on that. The directors should be forced to receive as complete a document as any officer or executive receives, whether they like it or not.

Q. Do you feel that in the long-form report of that type or some modified type, the auditor should point out significant developments or changes during the period audited?

A. Those would be items which would be commented on and pointed out in the report as a matter of routine.

Q. Changes between periods or unusual developments?

A. Any significant items of that sort.

Q. I take it from some of your earlier remarks that you might question the wisdom of including such statements in reports to stockholders?

A. I think so. Let me illustrate: Sometimes you must report in order to make the record clear that you do not like the way cashier Jones is handling his cash. I doubt whether you would want the world to know that.

Q. Let us restrict ourselves to something that would be significant to the investor.

A. Well, there is a question of policy. It would be very greatly to the interest of the investor to know how sales developments are coming along in a certain territory in terms of effort made and money spent, or what the attorneys have said with respect to the probabilities of success or failure in a pending lawsuit which may involve hundreds of thousands of dollars; but, on the other hand, the directors might say, "We undoubtedly have among our stockholders competitors who own one share of stock; or the chances are that the attorney for the plaintiff in this action or the defendant, as the case may be, has a share of stock, and should those matters go out?"

I don't think I would like to decide that matter now and here. But I think that the S. E. C. might well worry about it.

Q. How about the general disclosures along that line such as in the form of a statement of application of funds?

A. We incorporate in our work sheets, not invariably, an analysis of the cash in and out so as to account for the flow and the result, but with my point of view as to the mental capacity to grasp, comprehend, and take in figures on the part of the average reader, I believe such additions to the statements now issued would not prove useful.

Q. Possibly this would be simpler and we could omit some of the others. Now, turning to the question of the natural business year, do you actively urge the adoption of the natural business year in cases where a change seems desirable in your own practice?

A. Yes; for more or less selfish reasons and because it has become the fashion to do so.

Q. What would be the advantages of changes to that basis from the point of view of the accountant?

A. Most such changes would, I believe, not all but most, result in a change from a calendar year basis to some other basis.

That is a consummation devoutly to be wished. It would avoid the continued need for the use of so many temporary assistants, and would, I think, I am guessing now, prolong the life of accountants.

Q. Would it be possible to ascertain with perhaps more accuracy the correct financial position and the result of the operations in view of the fact that inventories would probably be lower and accounts receivable at an ebb, etc.?

A. That would undoubtedly be a fact: restrict, minimize the items with respect to which certainty is within limits attainable, only within limits attainable, and you improve the quality of the report, I believe.

Q. Now, generally speaking, Dr. Klein, 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. If I said "yes," I think that would rank a perfect mark in a C. P. A. examination, but I don't think it would be true.

The purpose, in my opinion, is to ascertain the true financial position and operating results. As a means to this essential end, but only as one of the means thereto, it is ascertained that generally accepted accounting principles are observed and that they have been consistently applied. I think the emphasis is upon the wrong element. Pardon me, I think in the question the emphasis is upon the wrong element.

Q. Will you indicate briefly the items in the balance sheet and income statement which the auditing procedure which you follow establishes to your satisfaction by tests or confirmations which are independent of both the accounting records of the company and the information which you receive from officers and other employees?

A. I will outline those items, but it is to be understood that I think that they are equally available to every practitioner and not to my own firm.

Q. I mean the procedure of your firm.

A. Cash by direct confirmation and by actual count; accounts receivable to the extent confirmed; notes receivable similarly and, to some extent, by physical inspection; securities by actual examination or by confirmation from custodian; real property by certificate from counsel; merchandise to the extent of the spot check or actual supervision of inventory taking, or confirmation from warehouses; liabilities to the extent directly confirmed by creditors; outstanding capital stock by certificate from registrar and/or transfer agent; funded debt by certificate from trustee; as to income and profit and loss items, only incidentally as reflected by confirmations referred to in connec-

tion with other items, the asset and liability items; income from securities and other investments can be independently confirmed from financial publication sources and by checking through banks.

Q. You say it can be there. Do you mean that they are?

A. Yes, they are in most instances. We know that the securities owned are as per list; in most instances we know what the income therefrom should be; the books reflect that income; and we check the income into banks and to that extent we feel there is some element of independent confirmation. Contingencies through the media of certificates from attorneys.

My response is intended to indicate the items which my firm can and frequently does confirm independently. It is not to be understood, however, that in every engagement this complete confirmation is indulged in.

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

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

A. Not quite.

Q. Will you explain yourself there?

A. It would be more correct and again it is a question of emphasis, to state that the "certificate" informs the readers that, in the opinion of the independent accountants, the examination has been sufficiently comprehensive to justify the expression of a belief that the financial and operating statements to which the certificate applies are correct and that, in the accountant's professional opinion, there is sufficient justification for such belief. I put it that way because of some language in the late Judge Cardozo's decision in the *Ultra Mares case*, about being guilty of "pretense of knowledge where knowledge there is none," you will recall.

Q. Going back for just a moment to one of your previous answers, to what extent would you say that the auditor should rely upon information received from officers and employees as to changes which may be ascertained directly?

A. That depends on circumstances. The ideal situation would be to take nothing for granted, confirm all accounts receivables which can be confirmed; confirm all liabilities—but there is a relationship, of course, between cost and what that cost will obtain for you.

I believe there are those who preach, even if they don't practice, that anything that can be confirmed should be confirmed. There has been a tendency, as you know, throughout the years, to rely upon test confirmations rather than complete confirmation, and despite a number of very dramatic incidents, unfortunate circumstances, by and large testing has justified itself.

Q. Have you anything further to add, Dr. Klein?

A. I would like to make one more statement.

Q. Please do.

A. It is in response to your question 129 about offering comments, and it is a rather brief one: I have attempted to make my answers

responsive to your question. In doing so I may have misled you and, if so, it was unintentional, of course.

Let me explain: No answer can completely exhaust a given topic; but, much more important, no answer can sufficiently emphasize that in every actual situation the procedure may well differ from that described in the answer, because what is done, so far as the partner and the supervisor are concerned (and sometimes even the senior), depends so much on the exercise of discretion and judgment—factors which depend in turn on informed knowledge, training, and especially on experience.

In brief, therefore, answers to the questions which you propounded may well be described as more or less theoretical approaches to the subject, and the implications in such answers must always be weighed in terms of actual practice.

It was in this spirit that I pointed out the inescapable limitations of the institute's bulletin; excellent though it is; it is after all only an attempt to suggest in broad outline some of the steps which may be taken to establish the general correctness of financial and operating statements.

Every step suggested in the bulletin may be taken and the result may yet be deplorable; many of the suggested operations may be omitted and other procedures adopted, and the result may prove excellent.

Unless there be borne in mind the human factors: Character, integrity, knowledge, alertness, imagination, spirit of inquiry, energy, resolute pursuit of doubt, continual supervision of field workers, and statement drafters, reading of the bulletin may lead to warped impressions of the scope and extent of the independent accountant's examination and the significance of, as well as limitation on, his certificate.

These hearings will, it seems to me, have been justified if they will aid in the education of the public to a saner and more realistic understanding of the function of the independent accountant. Such education, it seems to me, must inevitably lead to greater public appreciation of the indispensable contribution of the profession and to an appreciation that the accountant's service has discouraged fraud and misrepresentation and, except in the rarest of instances, discovered and exposed error and dishonesty. Even the most skilled physicians cannot save every patient, but we could not and would not do without the doctor.

And may I add that for quite a few years independent accountants have attempted, with but indifferent success, to make clear not only to clients, but to banks and commercial credit grantors and to investors, the necessarily practical limitations of the results of auditing.

When the certified statement reveals that each share of stock has earned, let us say, \$9.50, and that behind each share of such stock there are net assets of \$110, the accountant is satisfied with his performance if the variation as to earnings is not more than a few cents plus or minus and if the net value per share is slightly more or slightly less than the figure given.

All this is so because the accountant has deliberately restricted his examination to fair tests. If complete examination of all transactions were to be undertaken, the cost would be out of all proportion

to the added security attained and, in fact, such costs would in many instances be unsupportable by industry already overburdened by overhead. Selfishness might impel the auditor to advocate complete examination of every transaction, but both common sense and fairness, justified by the experience of years—a justification not negated by the exceptional unfortunate situation—impel support, by and large, of existing procedure.

The fact is that the test type of examination has detected innumerable frauds, but, much more important, has undoubtedly deterred and discouraged would-be crooks. I suppose that a thorough medical examination by a competent physician each week would nip in the bud much incipient disease, but what conscientious physician would advocate such procedure, or how many people would be willing to subject themselves to such examination or to bear the cost thereof.

Mr. WERTZ. May we now adjourn to Monday, March 13, 1939, at 10 a. m.?

The EXAMINER. Yes; the hearing is adjourned to Monday, March 13, 1939, at 10 a. m.

(Whereupon the hearing was adjourned until 10 o'clock a. m., March 13, 1939.)