

Q. If you had a few large receivables, and a lot of these small ones, as in one of the cases you mentioned, would you think it feasible to confirm the large ones and not confirm the small ones? Would that have any benefit?

A. It would have a partial benefit, certainly. I think it is less desirable.

Q. How about the relative value of a positive and negative confirmation, where there are some large and some small accounts, as to the large ones?

A. I think there is a little advantage in the positive, but in my opinion, very little, as compared with the negative.

Q. Now, on page 34, under "Accounts Receivable," Mr. Wellington, you will find a statement that under certain circumstances, a relatively limited test of the individual customers' accounts may suffice.

Would you indicate what in your practice you consider to be a relatively limited test?

A. I am not sure what is meant by that. Our practice is to do the necessary testing by aging the accounts, even if there is a good system of internal check, or to take the aging that the clients' employees themselves have made, and test that with the ledgers.

If this refers to the testing of the aging done by the employees, that would be our practice: To make a test of some 25 percent, or some other reasonable proportion of the total.

Q. In that case, you mean that you would have the company's employees get up schedules of the accounts receivable, with classifications to aid?

A. That is right.

Q. On the principles you have outlined?

A. Yes.

Q. And then you would test those schedules to see whether the work has been well done?

A. And test a number of them back to the ledgers.

Q. Yes; that is what I mean.

A. Yes.

Q. Do you have any different opinion as to the confirmation of notes receivable, as compared to confirmation of accounts receivable?

A. Customers' notes are, in our opinion, practically the same as open accounts.

Q. So that your thoughts there would apply?

A. Yes.

D. INVENTORIES

Q. Now, I should like to turn to inventories, Mr. Wellington. It begins on page 17 in the bulletin.

In your opinion, is an accountant responsible for the pricing of inventory in accordance with generally accepted accounting principles?

A. Yes.

Q. One of the methods commonly used in pricing inventories is that of cost or market, whichever is lower.

If determination of market prices is necessary, what do you understand to be meant by market price?

A. There are two tests of market. One is the market in the trade in which the product is sold, and the other is a reconstructed cost, if the price of the principal raw materials, or other factors entering into costs, have fallen to any appreciable extent.

Q. Are those tests used by different types of companies?

A. I think those tests are used generally.

Q. Now, the first of those—what exactly do you mean by that, market in the—how did you phrase it?

A. In the trade, that is, with the customers of the company, or the trade to which the company sells.

Q. You mean, then, that “market” in that connection is the trade to which it sells rather than the sources from which it buys?

A. That’s correct.

Q. You do not feel that “market” is the replacement market of the goods?

A. There are two ways of measuring market. I tried to make it clear that—

Q. I possibly did not understand those thoughts.

A. The replacement cost would be affected by the market of the principal raw materials.

Q. How about a company that does not change the form of its product? What would be the replacement market there?

A. The purchase.

Q. The purchase market?

A. Yes.

Q. Which of those markets do you use—do you intend to refer to when you say cost or market, whichever is lower?

A. Both, if both are affected.

Q. But do you feel that only one is affected at any given moment? That is what I want to make clear.

A. They might both be.

Q. They might both be?

A. In a case of a manufacturing business.

Q. I see. Now, what procedures do you employ to satisfy yourself that market prices used are actually applicable; that is, in regard to grade, quantity, and so forth?

A. The records will show the sales made during the recent period, that is, just before and just after the year end, of similar items; that is, prices actually obtained.

If there is no sufficient movement, there will usually be quotations that will be available, indicating the prices at which goods are offered, or sold.

Q. How would you determine that those quotations are applicable?

A. By proper tests, proper comparisons of the items.

Q. Will you expand that just a little bit? I am not quite clear as to what you have in mind.

A. You mean what identification of grade or quality?

Q. Yes, that sort of thing, and quantity.

A. Merely the identification that can be made from the type of records kept.

Q. Do you mean the records kept by the company, or the quotations given from whatever source you get them?

A. You have to match the two as best you can. That is, if you are depending on quotations from trade papers, you have to find out, if it is not perfectly clear on the face of it, which of the sales made or products handled by the company match with the particular trade information.

Q. Now, turning to items 9 and 10, as to inventories, would you explain briefly the procedure you follow in determining that goods held or shipped by the company on consignment are properly treated in inventory? I think you touched upon that a little earlier?

Q. You make the inquiry, of course, of the sales department, or credit department, as to the policy of the company, and then you get a statement from one or more of the principal officers as to the facts at that particular time.

Unless you get a direct confirmation, you, of course, would not be absolutely sure as to the existence of an item of that sort. An item might appear to be a sale, which actually was on consignment.

Q. Is it your custom to obtain confirmation of goods out on consignment?

A. Yes.

Q. If they are in significant amounts?

A. Yes.

Q. Now, I am not quite clear as to whether there is any test other than inquiry that you used in determining whether all the goods on hand are actually owned by the company, or whether some of those are with the company on consignment?

A. Other than a statement from one or more responsible officers, you are dependent on the records. Again, you can, of course, send the confirmations to the vendors, that is, the principal suppliers, in the same way that you do with your customers.

Q. That is, if there is a regular course of practice?

A. Yes.

Q. Of this company taking goods on consignment, you could confirm from the vendors whether any goods are with the company?

A. That's right.

Q. There would be no way of determining an occasional consignment?

A. Not except through the records. If the records didn't indicate that it was consignment, there would be nothing, as a practical matter, by which you could identify the goods.

Q. In your examination of the system of internal control, do you see whether a procedure for the treatment of that sort of goods is included?

A. In general, yes. The inquiry that you made as to practice, and as to the way they are handled, and the record that is made of goods shipped out, or goods received, should cover items of that sort.

Q. Now, what is your customary procedure, Mr. Wellington, to determine that there have not been included in sales goods which were shipped in subsequent periods?

A. Examination of the shipping records, sales records, in detail, for the period immediately preceding and immediately following the date of the cut-off.

Q. What records or documents or other evidence would you examine in that connection?

A. Whatever shipping records there are. There should be a detailed record in the shipping room of goods shipped out day by day, and coupled with that would be waybills, or express receipts, evidence of that sort, in addition to the company records itself.

Q. Now, what would you look for on those records, and on which of them? I mean, what would you have the staff man look at in this connection?

A. Look at the date and the item, and description.

Q. On which of those records?

A. Well, on all of them. That is, you wouldn't be limited to any one; that is, on what shipping records the company had, plus whatever collateral information is obtained by freight bills, or express receipts, data of that sort.

Q. Would your procedure be any different in establishing the cut-off if the goods were held otherwise than at the company's warehouse? That is, suppose it were held at an independent warehouse, over which the company had no accounting control?

A. You would depend there on a report from this warehouse.

Q. Suppose it were not an independent warehouse, in the sense of being a warehouse, particularly. That is, it is a vendor's warehouse, or a neutral party's warehouse. Would you require any additional—would you do anything in addition in such cases?

A. I think, as a practical matter, you must depend on the statement from this warehouse or vendor.

Q. Now, in verifying—I believe you verify to some extent the inventory footings and extensions that the company has made in computing its inventory?

A. That is correct.

Q. Do you do some of that?

A. By test, yes.

Q. Do you employ comptometer operators in that connection?

A. Sometimes, yes.

Q. Do you see any advantages or disadvantages in so doing?

A. I think it is a good plan where there is a sufficient volume.

Q. Are there any disadvantages in it where there is a sufficient volume?

A. I don't know of any.

Q. Now, what inquiries and tests is it customary for you to make to determine that purchase invoices for stock included in inventory have actually been entered into the books? What do you do in that regard?

A. Check the receiving records for the few days before and after the date of the inventory cut-off and trace the items into the inventory. That is, see that they either get in if they should get in or did not, if they should not.

Q. How do you determine that all stock received has actually found its way into the inventory? What do you do there?

A. Identify the items.

Q. Do you trace them into the inventory?

A. Trace them into the inventory.

Q. Physically, or by the accounting records?

A. See that they are properly put on the records.

Q. I see. Now, if you have completed the procedure as to inventories which is outlined in the bulletin and completed it satisfac-

torily, do you include in your accountant's report, or in the statements, a qualification as to your responsibility for the quantity, quality, or condition of inventories? Assuming you have gone through the test which this procedure calls for.

A. We usually put that qualification in a clause in our certificate, such as:

Accepting the inventory quantities as certified by the president, treasurer, or comptroller or whoever takes responsibility for them.

Q. Do you feel that is a qualification on the part of the accountant as to his responsibility for the inventory?

A. Yes.

Q. That is, it is a qualification on his opinion?

A. That's right.

Q. Would your thought be any different if that expression appears elsewhere than in the accountant's certificate? That is, suppose you don't include it in the certificate but as a footnote to the statement or in the balance sheet itself.

A. I don't regard it as particularly important where it appears. We generally include it in the certificate.

Q. In the certificate and not in the balance sheet itself?

A. It may be in both.

Q. It may be in both?

A. Yes.

Q. But if you clearly want to qualify, where do you put it?

A. Generally in the certificate.

Q. Now, if you have included such a statement in the certificate, do you feel that that avoids the necessity of making such tests as might be required by the last sentence of item 3. That sentence reads:

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

A. No; we make tests even if we depend primarily on the certificate. That is, the testing of the records.

Q. I see. Do you make any other tests when you have included such a qualification? Just what are the tests that you have in mind there? That is what I want.

A. To ask for the original inventory tags, sheets, or other records, and test them with the stock records and with the final inventory.

Q. And now, if you have not included any such qualification in your certificate, what test or inquiries do you make in connection with that sentence?

A. Our practice generally is, I believe, somewhat different from other firms, that we, wherever practical, do like to make test checks of the inventory quantities in addition to the mere check of the records.

Q. You have indicated there, "Wherever practical." What did you have in mind by that?

A. In certain industries it does not seem to us practical. I might illustrate that.

Q. If you will.

A. Take a case like the American Smelting and Refining Co. There the inventories are principally at the various smelters and refineries,

scattered geographically, as you would expect them to be, and much of the inventory is actually in process in the smelter or refinery. It is controlled by very complete, and we believe, satisfactory records which have been kept for many years. Also the nature of the business is such that the inventories do not fluctuate a great deal and in many cases we have the record of what the company paid the vendor for ores and we know generally what can be expected from them.

We do not think that examinations we might make would be of sufficient value to the company to justify the expense. That is, to make an examination which would be of any value we would have to employ a large staff of engineers and metallurgists, and even they would probably not know as much about the inventories as the company's own metallurgists know.

Q. Would you indicate under what circumstances you do make spot tests to distinguish the type of case?

A. We have just completed an examination for Revere Copper and Brass, Inc. Would you like to have the details?

Q. Yes.

A. At the request of the treasurer we spelled out in some detail this year in our report to the directors what we did. May I read it?

Q. If you care to, yes.

A. (Reading:)

We have received certificates from officials at the several divisions of the corporation stating that the inventory quantities were determined by actual count, weight or measurement, and that adequate provision has been made for imperfect or obsolete stocks.

The physical inventory was taken as at December 31, 1938, by employees of the company, who prepared duplicate pre-numbered tickets for the various items in the inventory, retaining the duplicate and leaving the original with the item inventoried. After the inventory count was completed, we accompanied certain executives through the plants, picking up the originals of the tickets and by various tests satisfied ourselves that the quantities as shown by the tickets were correct. We retained control of the tickets picked up and, upon accounting for all numbers and determining that the inventory had been properly taken, we traced individual items or totals to the inventory summaries prepared from the duplicate tickets. We checked the compilation of the inventory tickets and made substantial tests of the inventories at the fabricating divisions as to metal and product classifications.

In addition to establishing the correctness of the inventories as taken at the plants, we also confirmed with vendors and customers the quantities of materials belonging to the corporation at other locations or materials belonging to others in its possession. We also checked the mathematical accuracy of the calculations and summaries of the inventory sheets and satisfied ourselves that the prices used were at cost (considering the metal contents of the December 31, 1937, inventory as "cost" for 1938), which in the aggregate was below market.

Q. I notice that refers to the balance sheet as of December 31, 1938. Is that a fair statement of your practice prior to that time?

A. That has been the practice with this particular client ever since we have done the work, for a number of years. We merely spelled out the procedure at greater length because of recent developments and the opinion of the treasurer that the directors were interested in knowing just what was done.

Q. And there was no significant change in your procedure?

A. No change in the procedure, merely a change in exposition.

Q. Would you have in your certificate any explanation of that in connection with that?

A. The certificate is in what might be termed the usual form, but we add a phrase as follows:

In connection therewith we made sufficient tests of the physical inventories to satisfy ourselves as to their substantial accuracy.

Q. Had you included that phrase prior to this year?

A. Yes; that phrase has been used regularly ever since we have been doing their work.

Q. I think you mentioned you confirmed with customers and vendors the amounts. How did you do that? Were those amounts significant?

A. By letter. In this industry there is quite a bit of what they call toll business, where a customer will furnish the metal and they will fabricate.

Q. Do you know who they were, otherwise than by their appearance on the books?

A. You mean as to name, or did we have direct relationship with them?

Q. Either one or both.

A. No; we had no direct relationship with them. We merely confirmed by letter.

Q. In the case of those—I am not quite clear as to the practice in that case. Those goods were with Revere for fabricating, or were they at some other location and belonging to Revere, or both?

A. Both. The reference is primarily to customers' metal held by the company for fabrication.

Q. I see. Do you customarily make a review as to the methods which the client actually follows in taking its inventory?

A. Yes.

Q. And could you indicate briefly what, in your opinion, are the important points in a satisfactory method of taking inventories?

A. One of the most important is proper preparation, that is, proper planning; the decision as to when the plants will be shut down, in what form they will record the information, whether on sheets or tags or tickets, and how the material will be counted or otherwise measured as to quantity by the employees, who will check and then who will eventually pick up and assemble the primary information.

Q. Is that done by one or two crews of counters?

A. Usually by a number of crews, depending, of course, on the size of the business.

Q. Do those crews cross-check each other in any way?

A. Not usually. The original count would be made by the employees in the department where the inventory is, and then the cross-check would be made by another crew from a different department.

Q. Is the count by employees available to the crew that comes in to check it?

A. Usually, yes. That is a question of expense. It is not usually desirable to go to the extra expense of having the second crew count independently.

Q. How do you establish the observance of these points that you have mentioned by a client? What precautions do you take, or what examinations do you make?

A. If we are there at the time and supervise the inventory taking, we see what actually happens. If we are not we make inquiry as to what procedure was followed by the client's employees.

Q. Of whom do you make such inquiry?

A. Of the various people involved, presumably starting with the treasurer or comptroller and working down the line to one or more of the heads of the crews, to be sure that it was carried out satisfactorily.

Q. Do you customarily supervise the inventory in your practice? Do you do that in any great number of cases?

A. As many as possible. That is, we prefer to do that if it is practical. Out of all clients of reasonable size, not more than 20 or 25 percent.

Q. Do you feel that is more satisfactory than some spot checking of inventory?

A. Yes.

Q. You indicated it was a question of saving expense not to have the second crew count independently of the first. How would that saving come about?

A. The original counting must be done, or should be done, with great accuracy, as that is the record. The crew that comes along to check is merely interested in testing the accuracy with which the first work is done. They would merely make test checks. If they saw a pile that looked either much larger or much smaller than indicated by the ticket, they would either themselves check it or ask to have it reweighed or recounted.

Q. They don't actually recount all of the inventory?

A. No.

Q. They simply make a test check of whatever they think looks suspicious?

A. That's right.

Q. And would there be any systematic requirement as to test check of certain percentage of each department or each type of item?

A. I shouldn't think that was necessary.

Q. Leave it up to the crew to determine?

A. Yes.

Q. Now, if you find that the inventory methods followed by the client are not satisfactory, that is, they don't meet the requirements you have indicated, what position do you take then?

A. You mean as to the probable accuracy of the inventory?

Q. You come in and let's say you find this condition existing. In order to give a certificate, do you do anything different than if you find the system is adequate in conformity with the standards you have indicated?

A. We would feel that, if the system wasn't properly designed or properly carried out, we would have to do further checking of inventory records or of purchases and sales of materials for a reasonable period prior to the inventory, to satisfy ourselves as to the substantial accuracy of the inventory.

Q. Would you increase the amount of checking the physical count in such a case?

A. Wherever we take responsibility for physical count we endeavor to plan ahead of time with the client so that the inventory methods

that are followed are understood in advance and are satisfactory to us.

Q. Now, in appraising the inventory methods of a client, do you give any weight to the method they follow in receiving and shipping and storekeeping of the goods?

A. A great deal.

Q. You feel the findings there should be kept independent of each other?

A. Not necessarily.

Q. What would you expend so that—

A. It is a matter of convenience as to whether the stock records are kept in the receiving department or whether they are kept in another department such as the accounting office or costs department.

Q. Is it desirable to have them separated?

A. I don't think there is sufficient advantage in having them separated to justify the extra expense, if there is extra expense.

Q. Now, in your opinion, could an auditor be reasonably familiar with the general nature of the more important products manufactured or dealt in by the company? Do you expect your men to do that?

A. Well, generally; yes.

Q. I wonder if you would care to indicate the circumstances, or your feeling, as to whether you should take responsibility for an inventory, or whether you should include in your certificate a qualification such as you have indicated?

A. We welcome the responsibility where it is in our opinion practical for us to give it such supervision and satisfy ourselves in that way.

I think I made the distinction between American Smelting, where we don't think it is practical, and Revere, where we do think it is practical.

Q. Could you give us some other illustrations of where you think it is practical? I mean, general types of industries, if you can.

A. Where the product is of a nature that those who are not technically familiar with it can satisfy themselves as to quantity and quality and where it can be physically so handled that it can be checked with a reasonable expense.

Q. Who do you think should have the duty of deciding whether those conditions exist or not?

A. That would be up to the partner in charge.

Q. Up to the partner in your firm?

A. Yes.

Q. Would he consider that specifically in each engagement?

A. Yes, indeed.

Q. Now, as I understand it, you may either put a qualification in your certificate, a qualification on your responsibility for the inventory, or in the alternative you put in this phrase that you have made tests sufficient to satisfy yourselves as to the physical quantities.

Is the difference between the work that you do in those two cases the question of either supervising the inventory or making physical spot checks of it?

A. We don't include the phraseology in the certificate unless we do supervise or make sufficient tests of the physical quantities to satisfy ourselves.

In either case, we would make checks of the records.

Q. Yes.

A. But we don't add that phraseology to the certificate unless in addition to checks of the records we make sufficient tests of the quantities themselves to satisfy ourselves.

Q. Would you make physical tests such as you have indicated in any cases where you included the qualification?

A. Not generally.

Q. And would there be any cases in which you leave out both the stronger language and the qualification?

A. Yes.

Q. Under what circumstances would you do that?

A. Where the system of internal check and the system of records are such that after careful review we are satisfied that the inventory, as stated, is substantially accurate.

Q. Do you make any physical tests in such cases?

A. Usually not.

Q. You rely there on the system of internal control?

A. Yes.

Q. But you are sufficiently satisfied with it so you feel no qualification is necessary?

A. That's right. I have in mind one client with many thousands of items in inventory where they have a stock control which we have tested and checked many times. In my opinion, the inventory determined from those records is probably more accurate than it would be if they took a physical inventory. That is, the possible error in counting, I think, would be greater because they, as part of their routine, have two or more men every day checking certain items. They go through the complete inventory at least once, and usually twice a year.

I am using that as an illustration to indicate the other extreme where reliance on records, we feel, would be entirely satisfactory, where the client itself relies on the records and never takes a complete physical inventory.

Q. Is it your practice to make any general over-all tests of the reasonableness of the inventory quantities? For example, compare with warehouse capacity, average consumption, tax payments, insurance coverage; things of that sort?

A. I would say generally, no. I don't know of any case where we have made a test such as warehouse capacities or tax receipts.

Q. How about insurance?

A. It is very difficult in the average case to identify insurance with any one particular warehouse or even with the business as a whole, because many policies cover buildings and contents without keeping the contents separate.

Q. Do you employ the gross profits test in any cases?

A. Rarely. I think it has really much less value than would appear.

Q. Would you explain yourself there a little bit?

A. If you have a very simple case where they are making just one product, then it would mean something, but there are very few businesses in which they are making merely one product, and if they are making various products the relation—the increase or decrease

in the proportionate sales of one period as compared with the other would throw your gross profit tests out of balance.

Q. Suppose you used departmentalized figures in the case of a company making more than one product, would that increase the usefulness of the test?

A. It would.

Q. Would you use it in such cases?

A. Even there there would be a variation with difference in policy, but it would be of some value, yes.

Q. What do you customarily rely upon to determine the quantities, or to verify the quantities of merchandise held in independent warehouses? How do you determine that?

A. If they are really independent we would get a report from the warehouse.

Q. What do you mean by "independent" in that connection?

A. Really third parties. I mean not merely a branch of the company itself.

Q. Would you make any examination to determine that? What would you do to find out whether they were really independent?

A. There would be nothing other than possibly a general inquiry and what would appear to be the independence indicated by their form of statement.

Q. How do you determine the quantity of merchandise held at a vendor's warehouse? Would that be any different from the independent warehouse?

A. We would get a report from the vendor.

Q. If the amount involved were very large, would you make any further investigation of the particular vendor, as to financial responsibility, for example?

A. I don't know of any case where that has been done. Theoretically, you'd have the same problem there as you would with a customer, but practically, I think, you pay less attention to a vendor than you would to a customer.

Q. Why?

A. Assuming because he is a vendor rather than a customer, that he would be expected to pass along the materials in the usual course of business.

Q. Would any of those procedures assure to you that the vendor had not misappropriated the goods?

A. No.

Q. You would make no investigation to determine that?

A. No.

Q. Do you make any other tests as to quality and quantity and other conditions than those we have been talking about?

A. You would test the sales with the inventory of enough items to be satisfied that they were moving in the usual course of business. Sometimes a test of that sort will indicate that there is an unusually large supply which raises the question of obsolescence.

Q. Do you customarily make such a test?

A. Yes.

Q. When you say "supply," what do you mean there—supply on the part of this company, or supply in general, or what?

A. Supply on the part of this company.

Q. I see.

A. The general knowledge may or may not come to the attention of either the partner or the man on the job.

Q. Returning to the question of goods in the vendor's warehouse, does it make any difference in your procedure whether those goods have been paid for or not?

A. No. Well, to make that quite clear——

Q. If you will.

A. If they haven't been paid for and we have no title, they would be no part of our records.

Q. Well, you might have title even though you had not paid for them, could you not?

A. They might have been properly set up as a payable——

Q. Yes.

A. That is correct, yes.

Q. One further question, Mr. Wellington: When you make a spot check of the physical quantities of inventory, do you feel that that sampling process is an adequate method of verifying, from the accountant's point of view, the total physical quantity?

A. Yes.

Q. How would you perform that spot test? How would you select what to look at, or count?

A. A reasonable number of items, depending on the type of stock, and the facility for checking. It might be anywhere from 15 to 50 percent of the items.

Q. Do you think it would be desirable if auditors should do that in the future, wherever it is practicable, make some sort of physical verification?

A. That has been the practice of our firm. I think it is generally desirable.

The EXAMINER. Do you select particular items of magnitude, or small items, or mix them up?

The WITNESS. Mix them up.

(Discussion off the record.)

The EXAMINER. In the treating of inventories, do you consider dealings in futures, hedges, and commitments of the client?

The WITNESS. Yes.

The EXAMINER. Do you make a report on those subjects, in instances where that is a common practice? Do you embody that in your report, so that the stockholders, creditors, and others may know their position in respect to futures, hedges, and commitments?

The WITNESS. Yes; if there is any probable loss from such as a purchase commitment, or other commitment. Where the market has dropped below the price, and there is a potential loss, we comment on it, usually as a footnote.

The mere fact that the company may have commitments, unless they are unusual in size, would not be commented on, because that is usual in practically every business. Most businesses have some future commitments.

The EXAMINER. How about hedges against inventory?

The WITNESS. There again, in certain trades, it is a well-understood practice.

The EXAMINER. Do you comment on that in your report?

The WITNESS. Not unless it is unusual.

Mr. WERTZ. I have one further question.

Q. (By Mr. WERTZ.) Are there various ways of determining the cost of inventory? When you say "cost or market," on a balance sheet, does that mean that all companies follow the same procedure in determining costs?

A. No; there are a number of generally accepted ways of determining it. As far as raw materials are concerned, there is the first-in-first out plan, the last in-first out plan, the normal stock plan, and the average cost plan—just to mention four principal ones.

Q. Do you think the word "cost" in the phrase "cost or market" is ambiguous, since there are so very many methods of determining cost?

A. The important factor there is consistency in the company's practice. Where there is a change, the auditor should include in some way, usually in his certificate, a statement of the change.

Q. Well, from the point of view of the balance sheet, would the application of one or the other of these methods of determining cost result in quite different figures? Are they just minor variations?

A. It would for any one year; over a series of years, it should make very little difference.

Q. Well, would that mean that each of the balance sheets would be larger or smaller in successive years by approximately the same percentage, for example, as compared with another method?

A. Take the distinction between your first in-first out, and last in-first out.

Q. Yes.

A. On a rising market, on your first in-first out plan, you use up your low-priced goods first, and you have left on hand at the end of the year your high-priced materials.

On your last in-first out plan, it is just the opposite. As you go along during the year, you use up your current purchases, leaving on hand the inventory at the beginning of the year, plus the excess of purchases over sales, or minus the excess of sales over purchases.

Contrasting those two methods, if there is a distinct change in the price level, you get quite a different balance sheet, and quite a different income statement for that one particular year.

Over a series of years, the result in the total profit or loss should be very much the same.

Q. But the balance sheets at each period would be different?

A. They would be different, that is correct.

Q. Does the term "cost" include standard cost, as computed by the cost accounting system of the company?

A. Standard costs are primarily for the benefit of the management, in controlling operations, and seeing the efficiency with which the plants are run.

A standard cost is merely a predetermined cost, what an item should cost, or what is believed to be a fair cost, under current conditions.

The actual is compared with the standard, and the variance or variances, as to material, labor, and overhead expenses or burden, are usually carried in certain variance accounts.

At the end of the year, the inventory should be, for balance sheet purposes, put on practically the same basis as if it were at actual cost; though, if the standard at that time is below actual, many, or possibly most, firms use the standard costs as the most conservative.

Q. If a company were using standard costs in its balance sheet for inventory purposes, would you expect them to just say, "cost or market, whichever is lower," or "standard cost," or what?

A. The standard cost, unless very far from actual at that moment, I think, is perfectly sound to use as "cost" without explanatory comment.

Q. I see. Would you indicate also to what extent during the physical checking of inventories you have suggested—to what extent that would increase the cost of the audit?

A. In our experience, anywhere from a quarter to a third.

Q. Of the other cost of the audit?

A. Yes.

Mr. WERNTZ. May we recess now?

(Discussion off the record.)

The EXAMINER. We will recess until 2:15.

(Thereupon, at 12:40 o'clock p. m., a recess was taken until 2:15 o'clock p. m.)

AFTERNOON SESSION

E. OTHER BALANCE SHEET ITEMS

Q. (By Mr. WERNTZ.) Mr. Wellington, if you will refer to item four on page 21 of the bulletin. There are the instructions there to determine that amounts capitalized represent real additions or improvements. That instruction is in connection with the examination of the property, plant, and equipment. How do you determine that amounts capitalized have been actual improvements?

A. By inspection of the invoices backing up the additions to the plant to such extent as they represent purchases of equipment or whatever the assets may be, plus a check of the labor of installation and other expenses, if any such expenses are added, to determine whether, in our opinion, they are reasonable.

We also test additions with the plant ledger, if there is a plant ledger, or a similar record is kept, and where there is any question in the mind of the man making the check, also take it up with the plant superintendent or engineer.

Q. Do you make any physical inspection of the plant for that purpose?

A. No.

Q. Even though the item may be very significant?

A. Not usually.

Q. Incidentally, do you in the course of the annual audit, go out through the plant at any time?

A. We investigate that. There is no fixed routine, but we encourage the men, particularly the senior, to make such a quick review of the plant.

Q. Do you think that is a desirable thing to be done just to familiarize the auditor with the physical assets of the company in a superficial manner?

A. I do.

Q. Do you have any particular procedure to determine whether plant units have been abandoned and therefore should be removed from the asset account?

A. We inquire as to that fact from the people who will be most familiar, such as the superintendent, in addition to such inquiry or such record as there would be in the accounting department.

We also have somewhat of a check on that through any changes in the depreciation charges.

Q. Do you make any physical inspection of units that apparently are nearly fully depreciated on the books?

A. No; not as a rule.

Q. Do you make any inquiry as to units that have been fully depreciated and are still in use?

A. Not as a rule. That would be a difficult matter to determine other than by physical inspection.

Q. You don't make any particular verification of these items?

A. No.

Q. Now, as to insurance charges, how do you determine the proper amount of insurance expense to be allocated to a particular year? What procedure do you follow in that connection?

A. We as a rule check the policies or get a statement if the policies are not held in the office where we can see them, and check with the insurance record to determine the basis of the calculation of the unexpired portion.

Q. You inspect, in that connection, not only the policy but the insurance records, that the company maintains?

A. Yes.

Q. Do you make any other use of the information gained in that work?

A. Merely to see whether, in our opinion, the properties are covered.

Q. You feel that is part of the auditor's duties, to check the question of whether insurance is adequate or whether they use self-insurance, and if so, whether proper provision has been made?

A. Generally; yes.

Q. Now, turning to page 24, item 2-C under "Accounts payable." The suggestion is there made that the auditor make a test examination of the monthly statements received from creditors having large balances. What sort of a test examination do you make, and is that a customary part of your procedure?

A. It is customary to make an examination of such statements as are available and we frequently confirm balances, either by test or in full. As a general rule, the confirmation wouldn't be made covering them all and we wouldn't attempt, if they were large in number, to check every item, but we do make test checks of those statements that are available.

Q. Do you request the client to save monthly statements that come in around the first of the year for this purpose?

A. Not as a regular routine.

Q. You would make use of them if they were available?

A. If they were available; yes.

Q. Now, on page 8 again: Four lines up from the bottom of the page, you will find this sentence in connection with the description of internal check and control:

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

What importance has that to your mind?

A. Well, that is one of your methods of internal check to safeguard the handling of cash.

Q. Specifically, what does it do here? What does this step do?

A. Different departments or individuals approve the invoices, insuring that the goods have been received, and that they are properly priced, and checked, and that the invoice is ready for payment, and then, with that approval, it would go through the proper disbursing officer.

Q. Who is independent of them?

A. Independent of the man who does, or the department which does, the checking.

Q. Do you instruct your auditing staff, or the seniors, to have a general knowledge of taxes, which impinge upon business.

A. Generally; yes.

Q. What do you mean by "generally" there?

A. They have a knowledge of the usual taxes, that is, like the local real-estate tax, State income tax, or franchise tax, if there is one, the Federal income, capital stock, and other taxes that apply to most clients.

They would not be expected to be familiar with every tax in every State of the Union, or every foreign country in which the company might do business.

Q. In connection with the particular audit, would you have them make special inquiry to determine what taxes were applicable?

A. Yes.

Q. To the company?

A. Yes.

Q. How would you go about that inquiry?

A. Of the department, if they had a department handling taxes; otherwise, through the comptroller, or the treasurer, or the officer in charge of that matter, in behalf of the client.

Q. Would you compare them with taxes in previous years, to see that the same taxes were being paid, or that they were not applicable?

A. Generally, yes; if of any size.

Q. Would you make any independent test to see whether there were taxes, or would you rely on the officers' statements in each case?

A. I don't believe we would be in a position to make an independent test, unless we happened to know of some item, and in that case we probably would not go beyond the officers.

Q. I see.

A. You mean such as verification with the tax authorities of a State?

Q. I am not speaking now of the amount of taxes, but of the existence of a tax—whether the corporation is subject to a particular tax. Would you make any independent check as to that?

A. None other than from the company, or possibly the company's attorneys, acting for the company.

Q. That is what I wished to bring out. Now, turning for a moment to contingent liabilities, what procedures do you follow to determine the existence and amount of any contingent liabilities?

A. We have a general knowledge of the way in which the business is done, as the result of our work and inquiries that are made. We

also make specific inquiry from the various officers as to the fact of contingent liabilities, or lack thereof.

We have a regular form of certificate regarding contingent liabilities that we ask one of the officers of the company to execute before the conclusion of the engagement, indicating, to his knowledge, whether there are or are not any that we may or may not have found in our examination of the records.

Q. Do you inspect any other records of the company in connection with that?

A. We would inspect minute books of the stockholders and directors, and possibly an executive committee, if there was an executive committee, indicating what agreements or contracts might have been entered into.

Q. Is it your practice to examine these minute books for any other purpose than determining the existence of contingent liabilities?

A. Approval of any acts or changes that may have been voted.

Q. And for general information that might be contained in them?

A. That's correct.

Q. What responsibility do you think the auditor should assume in respect of contingent liabilities? Should he make a qualification in his certificate, based on the fact that he does not always know that all of the contingent liabilities have been discovered?

A. The most that he can do is to report any that he finds. He is never in a position, of his own knowledge, to be sure that there are none that had not come to his attention.

Q. Do you think there should be some sort of indication of that in connection with the balance sheet?

A. I don't think so.

Q. Why not?

A. Because—well, I think it is without the scope of the auditor's responsibility to set forth something that wouldn't be disclosed by the records that he is customarily expected to examine.

Q. Would you discuss this question with the company's attorneys?

A. Yes.

Q. To determine the existence of suits, and so forth?

A. That is correct.

Q. Would you examine contracts that the company may have on file?

A. Probably not, unless there were some special occasion to do so.

Q. Would you make some examination to determine whether the contracts were very important ones that perhaps should be given special consideration?

A. Not as a general rule—only if we had some reason to think that that examination was necessary.

Q. On whom would you rely for information as to the existence of contingent liabilities, growing out of these contracts?

A. Usually either on one of the principal officers or the attorney.

F. PROFIT AND LOSS ITEMS

Q. Now, turning to the profit and loss statement for a moment, on page 30, in item 1, there is a suggestion that a working profit and loss statement be obtained or prepared in as much detail as is readily available.

For the purposes of that paragraph, would you obtain and utilize financial statements and analyses which the company has prepared, or would you make up your own?

A. For the average medium sized and large company, which I gather we are discussing, we would use the company's statement.

Q. Would you make any check to see whether those agree with the books?

A. We would make——

Q. Or with your statements?

A. We would make test checks of the important items, such as sales and cost of sales, and the principal classifications of expenses.

Q. Is it your custom to inquire of the company what sort of financial statements of this character they have——

A. Yes.

Q. Available for you?

A. Yes.

Q. In item 2, under that same general topic, there is a suggestion that the auditor obtain budgets, previous annual statements, and monthly statements. What do you obtain those for? What do you do with them?

A. To see if there are any unusual items, or unusual changes during the period under review, or in comparison with the previous period.

Q. Suppose that a study of those statements does disclose the existence of major changes. Then what do you do?

A. Make further inquiry, to be satisfied that there have been changes such as indicated, and to be sure that they are properly stated in the accounts.

Q. Are you looking there to obtain the reason why the change occurred?

A. It is more to be sure that it is not due to some change in accounting principles or methods, not because of an economic change in the industry.

Q. But you would find out about that economic change as a method of explaining the change in the statements?

A. If there had been such a change, that would be presumably the explanation.

Q. Yes; that is what I wish to bring out. Now, under item 3, under sales and cost of sales, on page 31, there is a procedure outlined for testing allowances to customers for returned merchandise, claims, and rebates. That appears in the latter two sentences of that item. What is the purpose of that examination?

A. You have two points there. One is to test as to whether there is any defalcation or shortage being covered by unusually large allowances to customers, which might actually not be made to the customers, but cover up a shortage; and the other is to see that, if there are in the trade usually substantial allowances—to see that proper reserve is made therefor, against the open accounts at the end of the period.

Q. What sort of a test do you make there?

A. Take a reasonable period of time, that is, 1, 2, 3, or 4 months, to actually check the allowances that have been made, in comparison with the business done with those particular customers, and then

make inquiry from the sales department and credit department, to be satisfied that they are proper, and in accordance with the trade terms.

Q. Do you check the vouchers accompanying the credit slips to see that they have been properly initialled and so forth?

A. That's correct.

Q. Now, speaking of the profit and loss statements, generally, Mr. Wellington, what, in your opinion, is the responsibility of the accountant for the proper classification of expenses and income? I refer here, for example, to classifying a particular expenditure as between, we'll say, maintenance and selling and general administrative expenses.

A. We would make as part of the review, or testing of the operating accounts, a check as to the distribution of enough of the vouchers or invoices to satisfy ourselves that in general they were following a sound and consistent plan. We would, of course, not know, without checking all the items, whether it was exactly correct, but we would check enough to satisfy ourselves that the company was following a consistent method and was making a fair distribution.

Q. Do you there look for all of the very large items throughout the year, or do you take all of the items for a particular period, or both?

A. All of the items for a particular period.

Q. Would you also examine them to see if there were any large items in other periods?

A. Probably not unless there was something in the period that we covered that would indicate the necessity for further check.

Q. If the amount of maintenance had significantly increased, what would you do? For example, would you make any additional checks in that case?

A. We would. That is, if it increased as compared with the previous year.

V. REVIEW OF THE ENGAGEMENT

Q. Now, coming to the review of the audit papers that have been prepared in the detail audit. In your own case, who is responsible for drawing together these individual working papers and preparing the initial or preliminary statements?

A. The senior in charge.

Q. He takes them, the working papers, prepared by the juniors, or by himself and works them into the form of a balance sheet and profit and loss statement?

A. That's correct.

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

A. The senior's papers are reviewed either by a supervisor or a partner, or possibly both.

Q. And what does that review consist of? Do you check the individual working papers into, let's say, the trial balance, or the balance sheet, or do you merely test the clerical adequacy of the statements, or what?

A. No; the review would be more to establish the accounting principles followed and the consistency of those principles. The clerical adequacy would be left to the staff members. I don't think a partner would ever check the individual items from one to another, to be satisfied that they were properly footed, every item was carried forward, but he would make a general review with particular reference to accounting principles.

Q. Is there no one in the firm that would key those in except the senior who prepared the preliminary statements?

A. In some cases we do have a working paper review, but that isn't general.

Q. To what extent is there a review of the individual working papers? I mean, take each one, say the schedule of checks outstanding, for example.

A. That is usually prepared by a junior or middler—semisenior.

Q. But would not be reviewed or examined by anyone higher than the senior?

A. That's right.

Q. Except, of course, if the occasion arose?

A. That's right.

Q. You indicated that the review by the supervisor, or the partner, as the case may be, was primarily for establishing the adequacy of the accounting principles rather than the adequacy of the auditing procedure, or does the supervisor do both?

A. The supervisor, or partner, would certainly inquire as to the adequacy of the accounting procedure, but I was answering your question of checking individual items from one sheet to another.

Q. How would he determine if the audit was satisfactory as according to generally accepted principles?

A. By asking questions.

Q. By inquiry?

A. By inquiry and review of the papers.

Q. Mr. Wellington, is there any formal program you follow in this review work, or have you indicated about such formality; namely, that a supervisor, or partner, goes over it for his own satisfaction?

A. We have a regular form of audit program which is checked following a regular routine. I am perfectly willing to put that in evidence if you would like it.

Q. I don't think that will be necessary.

A. It merely bears out, in general, what I have been saying.

Q. Have you covered the steps that that program calls for? I mean, the top steps relating to review.

A. The top steps only. I mean, as you might expect, it is a regular detailed program taking up every item.

VI. THE REPORT OR CERTIFICATE

Q. I didn't have reference to the detail we had been over earlier. Now, when you have the statements all prepared and reviewed, who is it in your firm who signs the certificate to accompany it, or the accountant's report?

A. One of the partners.

Q. Is that always the case?

A. In the case of a smaller concern where the work is done by an office where there is a manager, the manager has authority to sign.

Q. And that is specific authority just to particular persons?

A. Yes, sir.

Q. Does the partner always draft the certificate, or is that prepared in connection with the statements by the supervisor and senior?

A. It is prepared in draft form by the senior and reviewed by the partner.

Q. Is it your practice to use a certificate generally similar to that set forth on page 41 of this bulletin?

A. Yes.

Q. What do you understand to be the function, or purpose of such a certificate, Mr. Wellington?

A. To indicate that the independent accountant has made the examination as set forth and to express his opinion.

Q. Speaking of a certificate in this form, what impression do you think is intended to be conveyed? What are you trying to say to the person who reads it?

A. That the independent accountant has made, what in his opinion is a reasonable examination of the accounts and expresses his opinion as to the substantial accuracy of the financial statements which it accompanies.

Q. Have you any thought as to whether that opinion has succeeded in getting across?

A. You mean to the general public or to the directors or—

Q. Classify your answer, if you would like to.

A. I think the general public has not a proper opinion as to what it means. I think many directors unfortunately don't realize of what the work consists, and just what the accountant has or has not done and for what he can or cannot take responsibility. I wonder in many cases whether there is anyone except possibly the comptroller that does appreciate just the significance of the wording in the certificate.

Q. And the accountant.

A. The accountant himself.

Q. Yes.

A. I hope he does.

Q. Could you indicate what, in your opinion, was the original function of auditing; that is, going back some time in the past?

A. Well, I remember when I first began practicing in 1907, the principal emphasis was in checking up the employees. There was very little checking up of the officers and directors. In fact, that was resented hotly by many at that time. They were glad to have the employees checked, but they didn't think it was any function of the auditors to check them. And there was a special reference at that time to cash audits and attempts to discover possible defalcations or shortages.

Q. Now, looking at the second sentence in the form of certificate, is it your understanding that this sentence is intended to convey a reasonably comprehensive description of the scope of the audit?

A. Yes.

Q. That is, the scope of an audit is generally in conformity with this bulletin?

A. Yes.

Q. Is the scope of the audit to be performed more extensively described in the audit engagement, or less extensively than this, in your experience?

A. I am sorry; I don't think I caught your question.

Q. You generally have a letter of engagement with a particular client, do you not; or do you?

A. Customarily not.

Q. Do you have any written statement made available to the client of what the scope of your audit is to be?

A. Not generally.

Q. Do you have any agreements with them?

A. Not generally.

Q. Does that mean, then, that you perform such an audit as you think is necessary under the circumstances?

A. That's correct.

Q. And you do not agree with the client as to what that audit is to be in detail?

A. Not as a rule.

Q. Now, about this question of checking inventories that you mentioned before.

A. That matter we do have to take up with the client to find out whether they are willing to incur the extra expense of having that done.

Q. And then you reflect the results of that in the certificate in the manner you have indicated?

A. That's correct.

Q. How about confirming accounts receivable?

A. Similarly. We usually take that matter up with the client and arrange to make confirmation unless they have some objection.

Q. Do you think that in all cases of that sort, the certificate should indicate any limitations on the scope of the audit that has been agreed upon with the client?

A. If important.

Q. Would you indicate some that you think might be significant enough to be included in the certificate? I think you have already indicated the inventory.

A. That would be the principal one. It isn't customary to indicate anything definitely about confirmation of receivables or payables.

Q. Except in the case of special companies like, say, investment trusts.

A. That is correct.

Q. Would your opinion—would you say that if a step which is required by the bulletin in its minimum procedure, that some indication of it should be given in the certificate?

A. Well, I don't regard the bulletin as a hard and fast minimum. It is simply a suggestion as to what is fair average procedure.

Q. You would, then, make your own determination of what is an essential step?

A. That is correct.

Q. Would a step possibly be so essential that unless you were permitted to make it, you would not complete your engagement?

A. If there was a step that we felt was necessary, and we were not allowed to make it, we would have to refuse to complete—that is, withdraw.

Q. Now, going on to the last paragraph of this certificate, Mr. Wellington, would you indicate there the language which indicates that there has been no material change, either in accounting principles followed, or in the manner of their application, as compared with the preceding period?

A. The words "consistently maintained" cover that. Wherever there has been a change, we insert phraseology indicating what the significance of the change was. We say, "maintained consistently, except * * *—as outlined in the preceding paragraph," or whatever the exception may be.

Q. Now, are you referring there to procedures that are consistently maintained during the year, or consistently maintained over a period of, say, 2 years?

A. Well, at least consistent with the preceding year.

Q. At least consistent with that?

A. Yes.

Q. As I understand it, you feel that the phrase, "consistently maintained by the company during the year," includes maintained consistently with the previous year. Is that correct?

A. That is correct, yes.

Q. Do you think there might possibly be some improvement in that?

A. I think, while that is understood in the profession, that it is not as well understood as it should be by the public.

Q. Do you use this form, or some modification of it, in your own certificates?

A. Yes, we do. We use this form with certain modifications.

Q. Do you have any modifications that deal with this point?

A. No.

Q. Unless there has been a change?

A. Unless there has been a change.

Q. Now, if you will look at the bottom of page 40, in the introduction to the accountant's report, there is language there which indicates that matter may be included in the accountant's report or in the statement, for the purpose of being either merely informative, or to state limitations on the scope of his work, or to indicate dissent from particular practices of the company.

Do you in your practice have any particular manner of distinguishing between those purposes as to particular language, so that the reader will get what you have in mind?

A. Yes; if we take exception to something that has been done, we would usually say, "except for" a certain item; if as in the case of inventories, where we do not take responsibility, we would say, "* * * and accepting the inventory as furnished to us by an officer of the company."

Q. Well, does the phrase, "accepting" mean that you except also?

A. No; accepting is as the—I believe its definition is to accept. "Except" is to take exception to.

Q. Well, now, would that acceptance of the inventories appear in the first paragraph? I mean, is that your custom, or would it appear in the opinion paragraph?

A. It might be in either, or both.

Q. Would there be any difference in the meaning you intend to convey there?

A. No; we are intending to put the reader on notice as to the facts.

Q. Well, now, suppose you included under the scope of the audit, "accepting inventories as certified to us," then does not the second paragraph read, "based upon such examination"——

A. That refers back to the first paragraph.

Q. I see. So that by putting that "accepting the inventories" in, you are saying that your opinion has nothing to do with the inventories; is that correct?

A. It says that as far as the inventory quantities are concerned, we have accepted the statement, without independent verification for that particular item of inventory quantity.

Q. Now, you say there that you put the reader on notice. Would you distinguish that situation from one which you intend to qualify, take particular exception to?

A. Particular exception would be as a rule in the second paragraph, or the last paragraph.

Q. And would not be in the first?

A. It might be in both.

Q. But it would be both; that is, it would appear in the opinion paragraph?

A. Yes.

Q. Would that be the case if you directly disagreed with the company's estimate of its inventory, for example?

A. That would usually be in the last paragraph; yes.

Q. Would qualifications of your opinion appear at any place other than the certificate? That is, would you put them in footnotes to the balance sheet, or in the balance sheet itself?

A. Well, we regard footnotes as part of the client's representation, rather than ours. We have no right to put a footnote on the statement of our own volition without the client's approval. The only place where we can put any qualifications are right in our own report or certificate.

Q. So that any explanation that is included in the footnotes, or the face of the statements, is accepted by you, unless you put a qualification in your certificate; is that a correct statement?

A. That is correct; that is, we endeavor to persuade the client that any information that we think is necessary to explain the statement should go in a footnote. That is, we endeavor to persuade the client that it is for his interest as well as ours to have the details spelled out sufficiently so that there may be no misunderstanding, and then in our certificate we call attention to the statements and the notes thereon.

Q. Is that meant to be an exception or an "acceptation," if I may put it that way?

A. That is merely information, explanatory.

Q. That is merely informative, and if you wanted to take exception, you would make a more positive statement with definite facts?

A. That is correct; that is, if we disagreed.

Q. Now, do you make any distinction in your own mind between a limitation on the scope of your audit, and an exception in your opinion, as to the financial condition of the company? I am not quite clear on that one point?

A. You mean where we might state, except for the fact that we did not make such an examination?

Q. Yes.

A. Generally, no. I mean, if we had any reason in our minds to doubt the part of the examination that we did not make, we would still make an exception.

Q. Would you certify at all in that case?

A. We would except—it depends on the importance of it. We sometimes say that we did not examine records kept in certain branches, feeling that they are relatively a small part of the total, and yet, they are important, and we accept those statements without detailed checking as part of the total. If we had any reason to doubt them, we would refuse to accept them, or we would put in a definite exception.

Q. I wonder if we could sum this part up by taking the phrase:

Inventories have been certified as to quantity, quality, and condition by the management,

and considering that you might put it on the balance sheet or in footnotes, or the company might put it there, or in the first paragraph of your certificate dealing with the scope, or in the second paragraph, dealing with your opinion, would you indicate just briefly again what you would be trying to say by putting it in those different places, first on the balance sheet—

A. The first paragraph of the so-called standard certificate would set forth the extent of the examination, and if we accept without verification the inventory quantities as certified to by an officer of the company, we would put that statement in the first paragraph, indicating scope.

Q. Yes.

A. We would not put any exception in the last paragraph, indicating opinion, having already stated the basis for our opinion; that is, that our opinion was based on the examination that we made, which, in this case did not include a verification of inventory quantities. An exception in the last paragraph is taken when we disagree with the results, not merely because we have not done as detailed or extensive an examination as we might otherwise do, either for that particular client or someone else.

Q. Now, what would be the meaning, if it were on the balance sheet, but not in the certificate, in any place?

A. I think that is just a question of practice and opinion. As long as the facts are set forth, I do not think it makes a great deal of difference which place it appears.

Q. Well, from your own point of view.

A. We customarily do include it in the certificate, but I should think it was just as good if it appeared on the balance sheet itself.

Q. Well, I think you indicated earlier that there were some cases possibly in which you would not put anything in the certificate at all; that is, either in the scope paragraph or in the opinion paragraph.

Now, under those circumstances, if the company included a footnote that you had not verified, what would you be trying to say by your certificate to a balance sheet which had that exception, or that piece of information in the balance sheet?

I am just trying to find out what your position would be, or possibly you never have had that case?

A. I assume that in that case, if it were spelled out, in detail, on the balance sheet, text, or in the footnote, that because our certificate would refer to the statements and notes thereon, we would think that was sufficient.

Q. It would be the same as if it were in the scope of the audit paragraph?

A. Yes.

VII. GENERAL SUGGESTIONS AND COMMENT

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

A. I should think it might be a good practice, if it did not happen too frequently.

Q. What would you say would be too frequently?

A. Well, say, once every 3 years or 5 years.

Q. You think that might be salutary for both sides?

A. I think it might be a good idea, yes.

Q. What would be the ratio that you approve? I mean, how often? Would 3 to 5 be the one, or is that too frequent? I think it is just a question of your answer not quite being on all fours with my question.

A. I should think less than 3 was too frequent; I should think more than 5, assuming that you were going to rotate, was perhaps not often enough.

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

A. Not customary.

Q. Do you think it would be desirable in either of those cases?

A. Generally, yes.

Q. What would be the advantages?

A. To answer questions that might be raised by stockholders or directors.

Q. Would you feel at liberty as an auditor to bring up questions that you thought the directors or stockholders ought to be concerned with, if you had the right to appear at meetings?

A. I doubt it. I think that to expect the auditor to do that would be throwing too much responsibility on him.

Q. Why?

A. Well, it would mean that he might be expected to be doing more than he reasonably could, from his position.

Q. You think it would put too much of a burden on his judgment, to determine what questions should be brought up and what should not?

A. Yes.

Q. Is that what you have in mind?

A. Yes.

Q. Do you send copies of your audited report, the detailed audited report, to directors, or do you send them to the management or the officers?

A. Customarily, to the management.

Q. Do you know whether they are sent to the directors in advance of the meeting, as a general rule?

A. We advise that, but I cannot say it is customary.

Q. Do you think it would be desirable if the auditor did mail them directly to the directors, so that they might consider them before the meeting?

A. I think it is a good idea, yes.

Q. Coming back to the auditor appearing at the stockholders' or directors' meeting, if you were supposed to be there, would you feel free to answer questions which the directors or stockholders might raise?

A. Only in connection with the audit and accounting.

Q. Yes; I had that in mind.

A. Obviously, you would not be privileged to divulge what might be confidential information.

Q. Do you think that might be a serious drawback, in trying to determine what was confidential and what was not?

A. I think most accountants would have good judgment on a matter of that sort.

Q. Now, do you think it would be desirable, or that accountants should in their detailed reports to the corporation point out significant developments that they have picked up in the course of their audit, or changes?

A. You mean economic or internal accounting, or procedures?

Q. Well, the changes in the financial picture, from the last time they audited—any developments they have come across in that respect?

A. We customarily do make comparisons, and indicate trends, but without any attempt to prognosticate or to advise as to what should be done.

Q. You do not make any recommendations?

A. No.

Q. Is that true also as to questions of internal control and defects in the records?

A. We would usually call those to their attention, but in a separate report.

Q. And suggest what is to be done about them?

A. Right.

Q. Do you prepare in that connection a statement of application of funds in any cases?

A. We usually do on the larger jobs.

Q. Is that sent to the client; I mean, is that sent to the corporation, or kept in your—

A. Oh, yes; as part of the procedure. It happens to have been done in this case that I mentioned this morning.

Q. I see. Do you also include comparative statements in your report, or just this year's, the current year's?

A. There is no definite invariable practice—usually, yes.

Q. Do you think somewhat similar figures might be included in stockholders' reports, or annual reports for public purposes?

A. I think it would be helpful.

Q. The suggestion has also been made that the adoption of the natural business year would be of considerable assistance in getting out better audits. What do you think of that proposal?

A. That would probably be as useful, or more useful, than any other one change.

Q. Would you explain that?

A. Because of the pressure under which work is done, the fact that such a large percentage of companies do close December 31—the calendar year closing puts a very heavy load on all accountants, which, if spread over the year, would make it possible to give greater attention to the individual clients, and also would be an improvement as far as the staff is concerned. That is, we would have to use fewer temporary men to take care of the peak, and because of the more regular work, we probably would attract in the course of time a better class of men.

The profession would be more desirable to the average young man who is considering the type of work he wants to take up.

Q. Would those benefits be in addition to the appointment of the auditor at the beginning of the fiscal year instead of perhaps near the close?

A. Yes; though the appointment at the beginning would enable a certain amount of work to be done during the year, but the changes in the fiscal year would be even more important.

Q. Would you say as a general matter 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. As a general statement; yes.

Q. Do you think that that is, shall we say, the major purpose of auditing at the present time?

A. I think that is the principal function of the independent accountants, as contrasted with the comptroller or other accountants employed by the company.

Q. Can you indicate briefly the items on the balance sheet and income statement which your own auditing procedure verifies to your satisfaction by tests that are independent of the accounting records, and, of course, of information furnished by employees?

A. Well, taking the items as they appear on pages 38, 39, and 40, customarily, cash in banks and on hand would be approved by outside information; similarly, marketable securities, notes and accounts receivable, if they were confirmed; inventories, when supervised—that is, when taking of inventory quantities has been supervised by the accountants.

It is not true generally of any of the other assets.

Q. How about property, plant, and equipment?

A. Unless there has been a recent appraisal there would be no basis for independent verification. That is, outside of the company records.

Q. How about tax bills, paid and so forth?

A. Well, I never happened to know of a case where the assessment had any clear relationship to the book figures.

Q. Well, you are distinguishing there as to the value, I suppose, of the existence of the assets?

A. You could determine that there were some assets.

Q. That's what I had in mind.

A. But you couldn't determine that the assets as called for by the statement were there.

Q. How about securities?

A. I mentioned that marketable securities you would usually see or verify from a custodian if some bank was holding them.

Q. How about nonmarketable securities?

A. You would see those. That is, you would see the certificates and see that they were either in the name of the company or its nominees and apparently owned by the company.

Q. Is there anything on the liability side that would be independently verified?

A. The notes payable would be verified by direct confirmation. The funded debt similarly with the trustee under the bond issue, if there is a bond issue, or with the holder of mortgages. The capital stock would be verified from the stock certificate books and the stock ledger.

Of course, if they were kept by the company employees, all you would have would be what appeared to be the complete record of capital stock issued and outstanding. In the larger companies, the stock would be checked through the registrar or transfer agent.

Q. Now, the second paragraph, coming back to the certificate again, Mr. Wellington, the second paragraph of the certificate states that in the auditor's opinion, based upon his opinion, the statement fairly presents the position of the company and the results of his operation. When you use this form of certificate 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 transactions? Is that what you have in mind when you sign such a certificate?

A. Well, I don't think I would quite follow your statement, using the word "verify." That is, you have satisfied yourself by the tests you have made as to the substantial accuracy.

Q. If we substitute for "verify" the language "establish to your own satisfaction."

A. Yes. That is, the certificate should not be given unless substantial accuracy of the statements have been established to your own satisfaction.

Q. And that is true even though you have included in the first paragraph some additional information as to the scope of the audit indicating that certain steps have not been done?

A. That's correct. That is, the omission of those steps would merely reduce the scope of the audit but you still wouldn't give a certificate if you had any reason because of the extent of your audit, to doubt the items. That is, you may have insufficient information but if the information you have raises any reasonable doubt in your mind, then you must go further.

Q. Well, to go a little further, would you sign such a certificate if, in fact, you thought that by not doing that test you had insufficient information?

A. No; not insufficient to satisfy yourself; no.

Q. So it is not only what you have done has raised nothing, but you are satisfied, yourself, that you have done enough to satisfy yourself?

A. That's correct, under the circumstances; yes.

Q. When you were speaking of rotating auditors a moment ago, did you mean there rotation of auditors in your own firm or rotation between separate firms?

A. I understood your question to mean separate firms.

Q. Yes.

A. We believe in our own firm there should be a certain amount of rotation. Sometimes it is difficult to persuade the clients because they prefer to have the same men with whom they are acquainted, so they don't have to answer so many questions.

Q. In addition to that, you were speaking of rotation among firms?

A. Yes.

The EXAMINER. In connection with rotating your own auditors, have you ever considered dual responsibility of seniors in the preparation of the final draft and report?

The WITNESS. I don't know of any case in which we have done that. We do have, wherever practical, a review of the working papers by a man who had nothing to do with the engagement but that is merely to check to be sure that all the various regular steps to be followed have been carried out.

The EXAMINER. But this reviewer has had no actual contact with the books?

The WITNESS. No.

Q. (By Mr. WERTZ.) One further question, Mr. Wellington. If you, as an accountant, are satisfied that you have made an examination sufficient to enable you to give this opinion, why do you include the phrase, "based upon such an examination?" What is the purpose there of that?

A. I suppose that phrase was originally suggested by attorneys as protection for the auditor. That would be the purpose of it, that it simply puts the reader on notice that your opinion is based on that examination. To, I think, any of us in the profession, it would be obvious that our opinion was based on that examination.

Mr. WERTZ. Have you any questions?

Mr. HENDERSON. No.

Q. (By Examiner HUMPHREYS.) Mr. Wellington, when you employ juniors, do you require any apprenticeship in any industrial work before you take them on?

A. We don't require it, but we prefer it. That is, we like to have men who have had 1 or 2 years of experience in actually doing book-keeping and accounting.

Q. I gained the impression that you had engineers in your organization. Is that true?

A. That is a fact. In 1935, we divided our work and formed another firm to practice the engineering work, which is somewhat affiliated, that is, we have partners who are partners in each of the two firms. Prior to 1935 we had engineers on our own staff.

Q. Do you use these engineers at any time in checking depreciation or amortization of facilities or in supervising and taking of inventories?

A. We use them on the inventories. We don't do any appraisal work even in the engineering firm, but we do use the engineers to quite an extent on the checking of inventory quantities.

Q. Do you make any difference in the type of examination or type of certificate where you make any examination for a bank or for credit purposes than where you make an examination for management or for the stockholders?

A. Usually it will result in the same certificate.

Q. How about the extent of the examination?

A. It would depend a little on the purpose. If you were making it for bankers, particularly in connection with a proposed new issue, they would be interested primarily in the earnings, and we would make a greater test of the earnings with particular reference to nonrecurring, or unusual items.

Q. How about short-time loans?

A. For commercial loans there would be primarily emphasis on the balance sheet.

Q. There you would go more into your receivables, and your inventory, than you would in the other type of examination?

A. I don't think so—possibly to some greater extent, but we would expect to cover receivables and inventory in the usual examination.

Q. Do you feel that the fact that the management employs the independent accountant influences the accountant in any way in his examination of the conduct of the officers?

A. Well, theoretically, no. Practically, it may have some effect. I think most accountants preserve their independence.

Q. Would you have any suggestion toward curing that, shall we call it psychological effect on the accountant?

A. It is always a good idea to have the independent auditors employed by someone other than the man he is examining. That is, I think it is always desirable to have the employment come direct from some other source such as the stockholders or directors.

Mr. WERTZ. Do you maintain that spirit of independence, Mr. Wellington, when you are doing special work for the client such as tax work and so forth?

The WITNESS. Oh, no, excepting that obviously no accountant is going to make a statement other than the facts as he finds them.

Q. (By Mr. WERTZ.) He has some leeway in finding the facts, perhaps?

A. No; I don't mean to imply that, but I mean the accountant in tax work has not only the finding of the facts but the interpretation and presentation of those facts in many cases.

Q. Do you feel it is possible for an accountant to be in that position for part of the year and then become completely independent at the close of the year for the annual audit, for instance?

A. He is performing two somewhat different functions.

Q. And you think he can separate himself?

A. I think so. Because there are some clients for whom we do tax work and some others for whom we do not, and our audit practice is no different in the two cases.

Q. You have indicated in answer to one of the examiner's questions that possibly the fact of employment by the management does color your judgment of their actions. Do you feel one of your duties is to check on the management at the present time or not?

A. Certainly if anything comes under our observation that we think should be called to the attention of the stockholders or other readers of the statement.

Q. I see. Now, you said one thing this morning in regard to the cost of making these additional tests of inventory. I think you indicated that it would cost from a quarter to a third more. What,

exactly, did you have in mind there? With what type of inventories would it cost a quarter or third more to make the tests you have in mind?

A. I want to make clear in the first place that, even where we check inventory quantities by suitable tests, we still make the same examination of the inventory cut-off and check with the receiving and shipping records. We go through the same motions for inventory verification that are done in the average case where we don't check inventory quantities, but the checking of inventory quantities gives us the additional assurance that the material is there. The work on inventories is a combination of seeing the physical goods and proper checking of the records. The extra cost is for seeing the physical goods and picking up the original tags and tickets and making such tests as are necessary.

Q. Would you distinguish the cost of supervising the inventory from the cost of going in afterwards and spot checking?

A. We sometimes do the latter, but only where the work cannot be planned ahead, where we are called in when it is too late. Spot checking after the inventory taking does some good but it is less satisfactory. To accomplish the same results, we have got to do more work.

Q. Will it be more expensive?

A. Yes, more expensive.

Q. And this one-quarter or one-third estimate refers to the supervision of inventory taken?

A. That's correct.

Q. (By Examiner HUMPHREYS.) I want to ask one more question there. This morning you discussed the question of internal checks. Where a principal officer of a company signed all the purchase orders, okayed the invoices growing out of the purchase orders, signed the checks for the payment of the goods, sold these same goods and okayed the invoice for the purchase price of that without anyone having veto power over him on that, would you say that would be a proper internal check on such a transaction?

A. Answering yes or no, I would say no.

Q. If you were examining the conduct of such an officer, what steps would you take to verify the genuineness of such transactions?

A. Well, you would endeavor to get whatever collateral information was possible to get.

Q. Would you go into the correspondence files or would you go, if this were a material part of the company's business, would you go as far as the correspondence files and contracts to see what was back of the transaction?

A. Normally, you wouldn't examine the correspondence files or contracts unless you had some reason to be suspicious. I mean, that is not customary except to get additional information such, for example, as a customer's account that seems somewhat doubtful, you might go into the correspondence files in the credit department to see what the status was of that particular company, but not as a general rule.

Q. Then, if you found that millions of these transactions represented inventories allegedly held by vendors off the premises, that had been paid for, what verification besides the ordinary confirmation, would you secure on that?

A. The usual practice would be to write, that is, secure by letter a written statement which would be returned, approved, or by request for a statement of inventories to be received direct by the auditor executed or signed by this other party.

Q. Would you go into the matter of the contracts or correspondence or other arrangements by which such inventories were held off of the premises?

A. Not normally; no.

Q. Could you place your position in the place of the public, or the stockholder, reading the certificate, and tell us what you think the public conception of that certificate really is?

A. Having been in public practice so many years I doubt if I can put myself in the position of the average person. I believe the average person on the street has very little conception as to what accountants really do or what their certificate does mean. Does that answer your question?

Q. Yes.

The EXAMINER. Anything else, Mr. Werntz?

Mr. WERTZ. Have you any suggestions, or anything you would like to put in the record?

The WITNESS. I don't think so unless you think of something that I might explain.

Mr. WERTZ. I think I have exhausted myself.

The EXAMINER. Mr. Henderson?

Mr. HENDERSON. No.

Mr. WERTZ. Thank you very much, Mr. Wellington.

(Witness excused.)

The EXAMINER. We will adjourn until Thursday at 10 o'clock.

(Whereupon the hearing was adjourned until 10 o'clock a. m., February 23, 1939.)