

I believe the limitations of determining market price should be emphasized as should also the important part which judgment and opinion must necessarily play in the determination of market prices. As a simple illustration I have in mind a retailing problem which is encountered from time to time where an item may have been acquired at a unit price of \$2. Its apparent replacement cost may be \$1.50, but no selling market is available at more than \$1, indicating that a merchantable value of the item should be determined for inventory purposes on the basis of a sales price less provision for selling and administrative expenses. The contemplated sales price may or may not be supported by sales subsequent to the date of the balance sheet.

If representative sales in the subsequent period are available as criteria, the problem is relatively simple, but if no such sales are available then the problem becomes one purely of merchandising in which strong reliance must be placed upon the judgment of informed officers and employees of the client.

As to quality, the accountant must necessarily rely very largely upon the descriptions reflected in the records concerning merchandise ostensibly in the inventory with a constant endeavor to note that these descriptions run consistently through the records in respect of the particular qualities under consideration.

Q. How do you determine, Mr. Stempf, that goods which the company holds on consignment, or which it has shipped on consignment, are properly treated in the inventory?

A. Well, one naturally expects to find records relating specifically to goods held on consignment or shipped out on consignment. If such records are maintained, there are, naturally, supporting documents which may be tested in corroboration of such records, augmented by reference to shipping and receiving department records.

In addition, it is our practice to obtain confirmations from both consignors and consignees as well as a written statement from responsible officers concerning their knowledge of the situation and the authenticity of the data reflected by the records concerning consignments in and out.

An important phase of this subject relates to the proper provision for inventory cut-off which calls for a definite instruction to all departments concerning the cut-off date and/or enabling a proper description between goods received and included in inventory and goods received and not included in inventory, goods included in inventory but shipped before the closing date, goods included in the inventory but held for shipment, and all other similar related factors.

Q. You mentioned there confirmation from consignors and consignees. Would you send a confirmation to a consignor with whom the company had had a regular course of dealings, but which, according to the records, had no goods with the company at the present time, or would you only send them to persons that the records showed had goods with the company? Have you any procedure in that connection?

A. Well, I can only answer you by analogy. We make a custom of sending confirmation letters to all banks with which a client may have done business throughout the year or at the close of the preceding year and it is my belief that we would normally send similar confirmation letters to all consignors or consignees with whom they may have done business during the year.

Q. Would you make any other tests to determine that—determine whether the company, in fact, owns inventories which are on hand, known to be on hand?

A. If perpetual inventory records exist (and the maintenance of such records is constantly urged and recommended) we test the maintenance of such records and scrutinize general ledger control accounts which relate thereto. We make comparisons between the perpetual inventory records and the physical inventory summaries. We confirm by correspondence, goods held by others belonging to the client. Through the chain of corroboration afforded by the relation between receiving records, purchase invoices and accounts payable, we check the ostensible ownership of merchandise actually known to be on hand.

In certain cases where purchases may be identified by bale numbers, lot numbers, or otherwise, whether perpetual inventory records exist or not, a reasonable means of identification is afforded and used.

Q. Now, when you say "used" you mean you, in your audit procedure, would physically look at the goods, where they are identified by lot?

A. That is correct, giving us an ostensible identification of the goods, with the invoices that represent them.

Q. I see. Now, what is the procedure you ordinarily follow to determine that there have not been included in sales, goods which were shipped during the following period? What evidence do you rely on in this connection? What documents do you examine? Do you make any distinction between goods shipped from the company's own warehouse and those shipped from warehouses not under control of the company?

A. Shipping records and related documents should disclose goods shipped during the subsequent period and included in sales of the current period. If proper provision for cut-off has been made in the inventory instructions, proper internal control should provide for a prenumbering of sales invoices, shipping documents, et cetera, and in conjunction with express receipts and bills of lading or similar documents afford a means for checking this situation.

If goods are shipped from a warehouse not under the control of the company, it is the usual practice to rely upon confirmations obtained from such warehouses. Confirmation requests in this case should naturally make provision for an integration of the movement of goods in and out of such warehouse, with the cut-off provision relating to the inventory directly under the client's control.

This would usually mean some requirement of detail in confirmation replies relating to shipments made immediately after the closing date.

Q. In examining these documents what do you look for, particularly?

A. Principally, dates to see that they synchronize properly.

Q. Now, in verifying the accuracy of the company's work on inventories, footings and extensions, do you find it feasible and desirable to use comptometer operators or do you do that work?

A. Yes; we do so under the supervision and direction of our own assistants.

Q. Do you find any drawbacks to the use of that method?

A. Relatively little so long as you apply, in addition to the use of the comptometer operators, a general scanning of all inventory sheets which is usual in customary practice.

Q. For you?

A. By that, I mean glancing in general at the items shown on the sheet and the related extensions to observe anything which appears obviously incongruous or incorrect.

Q. Now, turning to the purchase side for a moment. What inquiries and tests do you customarily make to determine that purchase invoices for stock included in inventory has actually been entered on the books? What evidence do you rely on to establish that stock received has been included in inventory? What do you look for?

A. This again is a matter of provision in the inventory instructions for proper cut-off. Receiving records afford a means of checking against recorded purchase invoices to see that purchase invoices have been recorded as to materials received prior to the cut-off and conversely to properly ascertain the character and amount of goods in transit at the closing date for which we customarily recommend the establishment of liability and inclusion in inventory. These same receiving department records and supporting documents likewise provide the means of corroborating the representations of management, that all stock received prior to the cut-off has been included in the inventory. We make a representative test of purchase journals for a predetermined number of days prior to the end of the period and ascertain by reference to receiving records, physical inventories, and perpetual inventories that items received prior to the inventory date have been taken into inventory, and that the liability therefor has been established on the books.

We also make a similar examination of purchase journals for a representative number of days subsequent to the end of the period.

Again, by reference to receiving records, physical inventories and perpetual inventories to ascertain that items received after the inventory date have been excluded from the inventory. Similar tests relate to purchase returns, sales journals, and sales returns.

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

(Whereupon the hearing was recessed at 12:30 p. m. to 2 p. m. of the same day.)

AFTERNOON SESSION

Q. (By Mr. WERNTZ.) Now, Mr. Stempf, going on with the problems as to inventories, if you complete satisfactorily the procedures outlined in the bulletin as to inventories, is it your practice to include in the accountant's report or the statement a qualification as to your responsibility for the quantity, quality, or the condition of inventory?

A. No, we do not. We have relied upon the resolution adopted by the New York State Society of Certified Public Accountants in this respect, wherein it is stated:

If a certified public accountant reports on a balance sheet of a concern over his signature without qualification or special explanation as to the item of merchandise inventories contained therein, it shall imply that he has exercised care in his examination by making accounting tests and checks of the concern's books of account and other available records pertaining to merchandise inventory, that he has received all information and explanations he has required from the officers and employees responsible for the taking and valuation of

the merchandise inventories and so far as accounting methods permit, has satisfied himself as to their substantial correctness, but that as regards the information and explanations he has required and as to the ownership, physical quantities, description, quality, condition, marketability, and valuation of merchandise, he has relied upon the representation of the concern's management subject to such check as may have been obtainable from the records in respect thereto.

I might add to that, that if any such qualifying statement were made, I believe that it should appear in the accountant's report rather than in the balance sheet itself because I look upon the aggregate of the financial statements, and accompanying footnotes and explanations, as the aggregate representation of the issuer, and that the accountant's report independently expresses the accountant's opinion as to the fairness of such aggregate representations, and therefore any explanatory comment in the statement itself is not the statement of the accountant, but is the statement of the issuer.

Q. Would you distinguish there between placing such a qualification in the opinion paragraph and a similar qualification in the scope of the audit paragraph?

A. I realize that opinion differs on that subject, but I personally believe that if it is intended as a qualification logically it should be placed in the opinion section of the accountant's report.

Q. Now, you will recall this sentence in item 3 under inventories at the top of page 18:

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

If a qualification is included in your accountant's report, does that in your opinion relieve the accountant from making such tests as may be contemplated by that sentence.

A. I believe the independent accountant should make such inquiries and tests regardless of whether he makes the statement that he has relied upon responsible officers for the information as to quantity, quality, and condition.

What tests do you feel are contemplated by this sentence? Are those the ones you referred to in your description of the New York State Society's pronouncement on that subject?

A. That is correct, and these tests comprise generally such things as the comparison of physical inventory summaries with perpetual inventory records and general ledger controls, a representative comparison of count or tags or similar media, against the inventory summaries and the matters which have been referred to in previous questions in connection with the determination of inventory cut-offs.

Q. Do you make a review of the methods which the client follows in taking its physical inventory, and can you indicate briefly what you consider to be the important points in a satisfactory method of taking physical inventory?

A. We endeavor to have a hand in the preparation of inventory instructions and in any event urge the preparation of instructions relative to methods to be pursued and records to be maintained in taking physical inventory.

We usually suggest that someone in the comptroller's department be designated to serve as inventory manager to supervise and direct the physical inventory, from the viewpoint of the accounting depart-

ment. These instructions should include rules concerning cut-offs, physical counts, recording and calculating inventory, provisions for prenumbering of tickets and forms for the several operations to provide requisite control of the final summarization.

Such instructions should give attention to goods in transit, on consignment, in public warehouses, out for processing, etc., as well as to defective, damaged, obsolete or otherwise unmerchandisable goods.

These instructions should provide for the preparation of schedules from shipping department and receiving department records concerning the effective cut-off of inventory and related adjustments of receivables and payables.

The instructions should also provide for the preparation of similar schedules relative to purchase and sale commitments, with due regard to questions of market prices in relationship to costs, and with further regard to the relation of commitments to normal requirements, etc.

All of the tests referred to in the preceding questions relating to inventories serve to corroborate the degree to which these provisions have been observed. If we were not satisfied that quantities had been carefully determined and that quality and condition had received due consideration, we would extend the aforementioned test beyond that originally contemplated, to get further assurance.

We might arrange for recount tests to be undertaken by the client's staff, and in rare cases, in my experience, a complete retake of the inventory has been made. This is, of course, a costly step which should be resorted to only in most unusual and extreme cases.

Q. Now, in appraising the integrity and accuracy of the inventory quantities, quality and condition as represented by the client's inventory, do you ascertain and give any weight to the nature of the shipping, receiving, and stock-keeping records and, if so, do you place any significance on the independence of the personnel involved in these functions?

A. We do give weight to the character of the methods employed by the client in these matters.

The segregation of duties and the integration of records maintained by separate employees is a fundamental factor in all phases of internal control.

Q. In your opinion, Mr. Stempf, should an auditor be familiar with the products which are manufactured or dealt in by a particular client whose books he is auditing?

A. The answer is yes; bearing in mind that such knowledge on the part of the accountant is not that of an engineer or technical expert, but knowledge which involves ordinary business judgment.

Q. I think you indicated that where bales or other quantities of goods were clearly identified by numerical markings, you would probably examine them to see that they agreed with the records. Do you extend that beyond that; make spot checks of inventories in other cases?

A. We do. The audit steps which the independent public accountant may apply with respect to the quantities, qualities and basis of stating the amount of inventories, relates primarily to the evidence which may be found in the accounting records and underlying documents.

The independent accountant's secondary line of corroboration of inventories relates to physical inspection. Such physical inspection may lend assurance of minimizing errors, but it should be understood clearly that the technical identification of items is essentially a matter of engineering or appraisal which lies without the scope of the auditor's functions as such. Therefore, whatever the auditor may do with respect to physical inspection of inventories must be recognized as purely collateral and circumstantial, based upon ordinary business judgment and not as vesting ultimate responsibility for valuation, nor of determination of quantities other than those ostensibly identified.

Based upon this viewpoint, we do make spot tests of inventories by inspection, or actual observation of counting, weighing or measuring. We do not do so in all cases, but endeavor to apply the principle in some degree wherever possible.

Q. You referred there to the technical identification of goods as being a matter for engineers or appraisers, as I understood it. Is that correct?

A. That's correct.

Q. Is there any supporting evidence in the customary procedure of an individual concern upon which you could rely without adding an appraisal or engineering report on the identification of particular goods?

A. I think that's obviously the case, that ordinary judgment would justify reliance upon the prima facie evidence that a case which indicates that it contains peas as distinguished from beans probably does so because, substituting something which might be inferior in value to that which the package ostensibly contains would probably be more expensive than to provide the actual merchandise and there are any number of variations of that same principle.

Q. Is it your practice to make any over-all tests of the reasonableness of inventory quantities such as by comparison with warehouse quantities, trade statistics of production and consumption, average consumption of the particular business, tax payments, insurance coverage, and so forth?

A. Our general procedure contemplates a comparison of quantities reported to be on hand with the capacities of storage facilities and such other tests as to quantities as may be applicable. Particularly, as to whether inventories are normal in quantity in respect to previous purchases and sales, production capacities, etc.

But we rarely resort to trade statistics of production and consumption. If, by tax payments you refer to customs' duties and similar imposts, these are, of course, tested in connection with acquisition costs.

If, by tax payments, you refer to taxes directly applied against inventories, my answer is no. Such payments are usually quite arbitrary and not specifically related to quantities and costs included in the inventory. This is likewise true of insurance coverage which is just as apt to be in excess of amounts which should be insured as it is to be inadequate.

We do make a general comparison of insurance coverage in relation to all kinds of assets and risks, customarily covered, but we do not place undue reliance on such tests, nor do we presume to make such

tests in any sense as experts in insurance matters, but rather from the standpoint of ordinary business judgment for purposes of discussion of the subject with informed executives of the company.

Q. In item 21 under "Inventories," in the bulletin, reference is made to the gross profits tests. In your opinion, should that be applied to the aggregate over-all figure or to departmental analyses of sales and costs of sales?

A. The answer to this question depends upon the circumstances prevailing in the individual case, variations in gross profits being tied up with so many economic factors, such as price levels and consumer demands, labor costs, etc.

A sound interpretation of variations in gross profits must correlate volume as well as dollars.

In a company which maintains departmental cost accounts in meticulous detail, embodying both factors, units and dollars, a study of the elements accounting for variance in gross profits may be illuminating and reliable. In many cases, however, where factors of shrinkage, waste, spoilage, etc., are not available, thereby distorting the unit factor, the test may be only a rough rule-of-thumb device. Obviously, if departmental analyses of figures may be obtained without undue effort and expense and the independent public accountant is satisfied as to the propriety of departmental allocation of joint costs, etc., the application of the gross profits tests should be made by departments.

Q. In your own practice, Mr. Stempf, and subject to the limitations that you have indicated, do you employ the gross profits test in your checking of inventories?

A. We do, and I say that it is just as often a rule-of-thumb test as it is a reliable corroboration.

Q. What purposes do you have in mind, if you have any special ones?

A. I think I answered that generally in the preceding question. Broadly speaking, it seeks to corroborate the reasonableness of inventory quantities and to account for and justify variances in gross profits.

Q. Now, as to merchandise that is not under the company's own control in its warehouses. What procedure do you customarily rely upon to establish the quantities held elsewhere in independent warehouses and vendors' warehouses? Do you obtain any information as to the financial responsibility of these other people?

A. We customarily rely upon confirmations obtained from the warehousemen to corroborate the representations of management as to the quality and value of merchandise held in independent warehouses or in vendors' warehouses. Never in my experience have I attempted to independently verify financial responsibility of such warehousemen, relying upon the judgment and discretion of the operating executives of the client to satisfy themselves in that respect before entering upon such arrangement.

In some cases, of course, one is familiar with the existence of representative public warehouses, but this is rather unlikely when it relates to warehouses lying in distant parts of the country or foreign land. The matter would normally be discussed with responsible executives of the client.

As to merchandise left in the hands of vendors at vendors' warehouses, inasmuch as the factor of credit risk is involved, one would

naturally consider the offset, if any, reflected in unpaid accounts payable and discuss the subject of financial responsibility of the vendors with the client.

Q. Do you think that this procedure would disclose the misappropriation of goods by vendors or warehousemen?

A. This procedure would not disclose whether the vendor had misappropriated merchandise.

Q. Are there any tests as to quality, quantity, and condition that you make that were not already covered?

A. We observe in general the principles set forth in each of the 24 paragraphs presented in the bulletin relating to inventories which have in substance been covered in my answers to the previous questions dealing with inventories.

Q. Looking to the future, Mr. Stempf, what procedure do you think an auditor should use in verifying quantity, quality, and condition of inventory as distinguished perhaps from what has been done heretofore?

A. I believe that independent public accountants may reasonably extend their tests of merchandise inventories by way of counting, weighing, or measuring, and I should like to reiterate that whatever the auditor may do in respect of physical inspection must be recognized as purely collateral and circumstantial based upon ordinary business judgment and not as vesting ultimate responsibility for valuation nor determination of quantities other than those ostensibly identified.

The identification of items is essentially a matter of engineering or appraisal which lies without the scope of the auditor. I think that this distinction should be emphasized. I should deplore the creation of an undue reliance by clients, investment bankers, or the investing public upon the fact that the independent public accountant has participated in the physical inspection of inventory.

Of course, such participation should lend assurance of minimizing error, but must not be viewed as conclusively establishing the technical identification of inventories and the appraisal thereof.

In the case of inventories in the hands of independent and responsible third parties, I believe direct confirmation from such third parties should continue to be acceptable in lieu of such tests.

Committees of the American Institute of Accountants and of the New York State Society of Certified Public Accountants are conducting careful investigations into these subjects in the hope that practicable means may be devised for extending such tests.

The conclusions of these committees will be available in due course.

Q. One thing there: You referred to goods in vendors' warehouses. Did you have in mind there an independent vendor that is not an affiliated one or would your statement be any different if the vendor were affiliated with the company?

A. I have forgotten, for a moment, my definition of affiliated, but if you mean controlled—

Q. Controlled, controlling, or under common control with, I believe, is the language.

A. I wouldn't necessarily make a distinction. And there the accounts obviously could be examined and some report by independent audit could be had on the situation.

Q. Again, on the question of independent and responsible vendors, what procedure did you have in mind there to determine the existence of those two conditions, namely, independence and responsibility?

A. If there is no overlapping interest or control between the organizations, I think that is a curbstone definition of independence. I don't think we have to go beyond that. As to being responsible, it seems to me that we must still eventually rely upon the judgment of management as to the responsibility of such third parties.

Q. Now, as to the existence of those, shall we say, affiliations. Would you have any procedures to determine whether such affiliations exist, and does your first statement contemplate any investigation as to that?

A. I have none in mind other than the usual inquiries with responsible officers as to the existence of any such relationship unless there were disclosed, incident to the examination of other matters, the fact that some such relationship did exist.

Q. Now, in the earlier part of your answer, you referred to the fact that you would deplore the creation of any thought that by participating in physically confirming goods the accountant was taking more than an accountant's responsibility. That same qualification is present, is it not, in respect of, let us say, fixed assets?

A. Definitely so.

Q. Or accounts receivable, securities where you just count the evidences of those securities?

A. In varying degrees in respect of all classifications.

Q. One thing further: Do you think that it would be desirable for auditors to participate in or supervise the actual taking of inventory by their client as distinguished from spot checking after the inventory has been taken?

A. Within the limitations and from the viewpoint expressed in my answer to the previous question, I believe that it would be desirable for independent public accountants to participate or cooperate in the preparation of physical inventories. There are, however, other practical limitations which relate to this question.

There are still too many companies which close their books on the basis of the calendar year instead of observing the natural business year for that particular industry. The manpower required for effective participation in physical inventories at the calendar year-end is a material factor, an obstacle which is most difficult, if indeed not impossible to overcome. Corporations should be influenced to adopt the natural business year-end and in any event such participation should be held at periods other than at the year-end. I have in mind the extension of the adoption of perpetual inventory methods by corporations generally which, if effectively maintained, would very largely do away with the necessity of complete physical inventories at any given date.

The prescribed internal routine should make provision for staggering the corroboration of perpetual inventory records by the determination of physical inventories throughout the year, section by section, or department by department, with provision for effective reconciliation and adjustment of differences to be recorded immediately in perpetual inventory records and the books under proper authorization and approval of management.

This method may provide for complete physical inventory two or three times during any given year, and would afford reasonable opportunity for cooperation of the independent public accountant in such physical tests.

(Discussion off the record.)

Q. (By Mr. WERNITZ.) It is quite frequently seen in public statements, Mr. Stempf, a statement that inventory amounts are based on cost or market, whichever is lower, or some similar expression. I think you indicated that market had several different meanings, and does cost have several possible meanings in that connection also?

A. The word "cost" is used generically to cover quite a number of variations of the application of the principle. We have, for example, the practice of first in, first out, of last in, first out, base-stock method, and other variations of cost, any one of which may be quite appropriate when coupled with the cost or market whichever is lower theory, in application in a given instance, the vital factor being the consistent application of the method adopted.

Q. Would the use of different methods that you have described result in material differences in individual balance sheets?

A. If we take the viewpoint of a particular year, yes.

Q. I am speaking now of the balance sheet as opposed to the operation.

A. Of the balance sheet and of the operations both, but over a cycle of 5, 10, or 15 years, I doubt whether it would make a very great deal of difference in the averages of balance sheet amount or in the aggregate of profit and loss amounts. Consistency, therefore, is the vital point.

Q. Would that be true as to a base-stock method if you valued part of your inventory at the lowest price at which said inventory had been bought and sold for many years?

A. I am satisfied from not a great many cases but several studies I have made in that respect that that is equally true of the base-stock method.

Q. In view of the different methods of determining costs, do you think it might be appropriate to indicate which of those methods is followed or do you feel that this averaging out process by reason of consistent application takes care of that?

A. I shudder to think of writing an explanation which would clearly discriminate one of these bases of application of cost or market from any one of the others, and I think that we should be content so long as we know that the basis adopted is being consistently applied and I should like to interject there that consistency of basis does not necessarily mean that change may not be made, changes in technique, changes in marketing methods, many other reasons may occasion a definite change in procedure, but I think we uniformly recognize now that when a change in the application of a principle is made that it requires disclosure in the financial report.

E. OTHER BALANCE SHEET ITEMS

Q. Now, turning to fixed assets for a while on page 21, under item 4, how do you determine that amounts capitalized as additions

to plant represent real additions or improvements? Do you physically inspect them or what do you do?

A. Various methods, depending upon circumstances, are used to determine the amount capitalized as additions to plant, in independent additions or improvements, and quite a volume could be written on this subject alone.

In the vast majority of cases, it is relatively easy to determine whether the amounts capitalized represent real additions and improvements on the one hand or repairs on the other. In the borderline cases, determination is more difficult and here all the surrounding circumstances are taken into consideration in arriving at the decision, which decision necessarily must be a matter of judgment. It is quite usual to discuss such problems with the responsible employees of the company and quite often plant is inspected.

Q. What procedures do you follow in ascertaining that abandoned plant has been removed from the plant account, do you make any physical verification of assets which, from the record, appear to be approaching the end of their useful life?

A. I do not believe it to be customary to make a physical inspection of major items which the books reveal to be nearing the end of their estimated lives. Some clue to the abandonment of plant units is generally found in the books as the audit progresses. Such clue may represent the transfer of machinery or the discontinuance of a production unit.

Q. Now, turning to some of the other items on the balance sheet: What procedure do you follow in establishing the correct allocation of insurance charges as between the past year and future years and do you utilize the knowledge gained in that procedure for any purpose other than that allocation?

A. In checking the allocation of insurance charges, a general scrutiny is made to determine that the allocation is reasonable. Insurance in force is also examined to ascertain that all assets owned by the company are covered to the extent indicated in my previous answer which I might well repeat here.

Q. That was the one on inventory, was it not?

A. I said insurance coverage is just as apt to be in excess of amounts which should be insured as it is to be inadequate. We do make a general comparison of insurance coverage in relation to all kinds of assets and risks customarily covered, but we do not place undue reliance upon such tests, nor do we presume to make such tests in any sense as experts in insurance matters, but rather from the standpoint of ordinary business judgment.

Q. Now, turning to accounts payable, on page 24 of the bulletin under item 2-C, you will find the optional instruction:

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

What do you consider an adequate test in this respect?

A. Item 2-C on page 24 of the bulletin has been found unsatisfactory by us in a great many cases. Where there are large balances due to trade creditors, we quite often check these balances by means of confirmation.

Q. Now, in the last paragraph on page 8 there is a reference to the fact that approval and entry of vouchers will be made by others than the disbursing officer. Would you indicate the significance of such a requirement?

A. The procedure referred to in this question is part of the internal check as it should be enforced. It is one of the first principles of internal check that a person who disburses monies shall do so only upon the authorization of another.

Q. Do you require your auditing staff, Mr. Stempf, to have a general knowledge of taxes which may affect or impinge upon a particular business, both domestic and foreign?

A. We expect that at least seniors and to some extent semiseniors should have a general knowledge of all types of such taxes. Such knowledge should be at least sufficient to recognize that a tax problem exists. It may then be referred to our tax department where more thorough knowledge is available.

Q. Did you say "our tax department"?

A. Yes, our firm's tax department.

Q. Now, referring to contingent liabilities, what procedure does your firm follow in determining the existence and amount of this item, and also what responsibility do you take in regard to it?

A. Contingent liabilities are generally disclosed in taking the regular audit steps. These include such steps as confirmations, reading of the minutes of the board of directors and stockholders, examination of leases et cetera. We discuss the matter in some detail with responsible officers and obtain signed statements from them concerning such contingencies and likewise obtain statements from the client's counsel regarding litigation or other legal complications. We assume the responsibility to ascertain such contingent liabilities, subject always to the limitation of contingencies which may remain undisclosed, as the result, or rather in spite of pursuing these measures.

Q. Do you include any qualification in your certificate covering that feature?

A. Covering the limitation?

Q. Yes.

A. We do not.

Q. Do you examine stockholders', directors' and committee minutes for any purpose other than this?

A. Such minutes and contracts form an important part of the examination and it is the customary procedure to examine and review them at each examination.

F. PROFIT AND LOSS ITEMS

Q. And now, on page 30, in item 1, there is a suggestion that the accountant obtain a working profit and loss statement, or prepare it in as much detail as is readily available. For this purpose, to what extent do you utilize statements that have been prepared in the client's offices, or by the client?

A. Wherever available, we obtain and utilize financial analyses and statements, which the company has prepared. We compare these with

the controlling records of the company to see that they are in agreement and use them as a basis for further substantiation of details.

Q. Do you make inquiry to determine whether such statements are in existence?

A. As a regular matter of practice we do.

Q. And now, in item 2, there is a suggestion as to obtaining budgets, previous annual statements and monthly statements. What is the purpose of that? What investigation do you make, or what further study do you make of items disclosed?

A. The purpose of obtaining budgets and previous annual statements is to aid in ascertaining unusual items or unusual variances in items for the purpose of subjecting such matters to further inquiry. This will ordinarily take the form of obtaining the details of items in which significant changes occur, either by analysis of the accounts, by inquiry from employees, or by other means.

Q. Do you customarily make any recommendations resulting from your studies in that connection? That is, do you bring these changes to the attention—

A. (Interposing). In our own practice there has been a gradual transition away from that sort of thing. Particularly in the larger companies. In a great many cases the final statements bearing our reports are the only report issued. In such cases where the client requests detailed analyses, they are given. Usually, in a separate report.

Q. When you refer to statements bearing your report, you mean—

A. I mean the published final statements.

Q. Now, under item—in item 3, under "Sales and cost of sales," there is a procedure outlined for testing allowances to customers for returned merchandise, claims and rebates. Now, what, in your opinion, is the importance of such an analysis? Do you always make it?

A. Item 3, under "Sales and cost of sales," calls for an inquiry into the method adopted to safeguard credits to customers for returned merchandise, claims, rebates, et cetera, and a test examination to find out if the procedure is being followed. Where this item is substantial in relation to the net profit or loss, this procedure, in my opinion, should be followed. The importance of the procedure is to substantiate the propriety of customers' claims, and to discover irregularities, if such exist.

The item is present in different types of businesses, in greatly varying amounts and where the amounts are not material, the examination might be cursory.

Q. Now, speaking of the income statement in general.

A. May I revert for a moment to question 104?

Q. Surely, if you will.

A. I had an afterthought on that score. That the reason for the transition in that type of reporting, I think, relates very largely to the fact that the internal accounting and auditing and comptroller's departments of those companies have become very much more proficient in the production of that sort of material themselves and are much better able to devote the relatively long time and deliberate thought that is necessary for an intelligent and instructive analysis of those situations.

Q. Now, referring to the profit and loss statements in general. What, in your opinion, is the responsibility of the accountant for a proper classification of expenses in income, say, as between maintenance and selling expenses and what procedures do you utilize to satisfy yourselves on that point?

A. I believe that the accountant should satisfy himself that the income received and the expenditures are properly classified insofar as the facts are known to him, or ascertainable by reasonable inquiry. The steps taken in this regard generally comprise a comparison of the profit and loss statements, usually prepared by the company, with those of the prior years and with the budget, if available.

Supplemented by scrutiny of available details and investigation of significant items. And further supplemented by a review of the internal check and control.

Q. You stated there that you would review significant items. Do you also make a test check of, say, a month's records in more detail than that?

A. Definitely so.

Q. In addition to that, then, you try to pick out the more important items in other months?

A. That is correct. And, of course, there are some accounts appearing in the profit and loss which require complete analysis, really. Such things as taxes and interest. Items of that kind which must be tied up with related asset accounts and also which are required for purposes of preparation of tax returns and that sort of thing.

Q. Your responsibility—to go back a minute—your responsibility in this connection would also be affected, would it not, by the detail which may be required to be set forth?

A. Which may be required in the ultimate profit and loss statement which will be included in the financial statements concerning which we express our opinion.

Q. That is what I had in mind.

A. Yes.

V. REVIEW OF THE ENGAGEMENT

Q. Now, turning to the review of the statements by others than those working on them. Who is responsible in your firm for drawing together the results of the detailed audit program and preparing the initial financial statements, the first draft of them?

A. The responsibility for drawing together the results of the detailed audit program rests in the first instance, on the senior in charge of the engagement, under the supervision of a supervisor or partner. The papers are scrutinized by the supervisor during the course of the audit and then critically reviewed by him on the completion of the field work.

The financial statements are prepared by the clients usually and are checked by the senior and by the supervisor. The financial statements and the supporting working papers are then reviewed in more or less detail by the partner on whom rests the final responsibility for the rendition of the report. I would like to add that we strive to get the cooperation of clients in the preparation of their own financial statements, and that we in turn prepare them independently from our own working papers and check with them, reconciling any dif-

ferences which may appear, which affords an additional double check on the preparation of the ultimate statements.

Q. Who would prepare that set of financial statements that you make up; would that be the senior in charge?

A. It would be the senior in charge under the supervision and review of the supervisor.

Q. I see. And that would contemplate, then, a review by someone other than the senior in charge who is engaged in the actual field work of the audit—directly engaged. I mean, your review would contemplate that?

A. Whoever has prepared the statement is checked by someone in a superior position.

Mr. WERNTZ. Off the record.

(Discussion off the record.)

Q. (By Mr. WERNTZ.) Would you explain in just a little more detail, Mr. Stempf, what the purpose of such a review of statements is? What is it expected to reveal?

A. The working papers are prepared under the direction of the senior in charge of the engagement and he is responsible for them. As already indicated, the supervisor will: one, review the papers critically, two, check them to the financial statements, three, discuss required or possible adjustments with the client, either before or after reviewing such adjustments with the partner who has charge of the engagements, and, four, generally satisfy himself as to the treatment accorded the various items in the financial statements and as to the propriety of the treatment of any unusual transactions.

The supervisor will then discuss the financial statements with the partner and the partner will review the statements and the working papers in more or less detail.

The final and ultimate responsibility for all steps in the engagement attaches to the partners.

VI. THE REPORT OR CERTIFICATE

Q. Now, turning to the accountant's reports. Who in your firm would originally draft that? Who would sign it, also?

A. The only persons in our firm authorized to sign the certificate are partners. There is a single exception for one of our branch offices, in which we do not have a partner, where the manager in charge signs the certificate. The certificate may be drafted by the senior or supervisor but in any event it is subject to final review by the partner in charge.

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

A. It is.

Q. What do you understand to be the function of the accountant's report in connection with statements, financial statements?

A. It is the function of the accountant's certificate or report to set forth the scope of the examination and his opinion regarding the financial statements.

Q. What impression do you intend to convey by using a certificate in this form?

A. In an unqualified form of the accountant's certificate, we wish to convey the impression that we have made the usual examination of

financial statements, at least as extensive as that provided for in the bulletin, and that we have nothing unusual to report. Where exception is taken in the report or certificate, such exception indicates the degree of variation from the normal.

Q. Is there any limit on the degree of variation which might exist, and you would still furnish an accountant's report?

A. Obviously it must be material to justify an exception.

Q. Well, is there any limit to the number of material exceptions that you might take?

A. That situation rarely arises, but certainly, theoretically, one can assume that the extent of exceptions required in a report might make the financial statements as well as the report quite meaningless. Under such circumstances I am sure that we would prefer not to render any report, and probably would not do so.

Q. Now, looking at that form of certificate a little more closely, is it your understanding that the second sentence of the first paragraph is intended to be a reasonably comprehensive statement of the scope of the audit?

A. Yes. Here it is a question of deciding where to draw the line. Full details of all audit steps are obviously impossible, because they are so voluminous. The so-called long form of certificate goes only slightly further than the second sentence. The second sentence points out the general scope of the examination in conformity with the bulletin and indicates its limitations.

I should like to add there that the standard form of accountant's report cannot be read and cannot be understood unless the reader knows that it is directly related to the bulletin. And I am sorry to say that it is my distinct impression that there are relatively few investors who have any knowledge of that fact and perhaps to some degree a reasonable number of informed men who do not realize the relationship between the standard form of report and the pamphlet, and that in spite of the issuance of, I think, about 50,000 copies of the pamphlet.

Q. Have you any thought there as to how a better mutual understanding could be reached?

A. I think all of us should try to emphasize that fact whenever the discussion of accountant's reports, particularly in the standard form, arises, regardless of who may raise the question. I think if we can continue to reiterate the fact that the two must be read to be understood, that we'll do everyone a real service.

Q. Now, referring again to the scope of the audit. Do you extend that second sentence, for example, to agree with note 4 on page 41 of the bulletin?

A. Note 4 relates to consistency with the prior year.

Q. No, that refers to including confirmation of cash and securities by inspection or certificates from depositories confined to special cases.

A. We do not unless the clients prefer to have some elaboration of the report.

Q. Do you believe that any material omissions from the procedures or program, indicated in the bulletin, should be also indicated in the certificate?

A. Yes.

Q. May I ask there as to whether you ordinarily have a written form of audit engagement?

A. We have an engagement memorandum relating to every assignment we undertake.

Q. Would the description in that memorandum as to the scope of the audit be more extensive than this sentence or less extensive?

A. It would be a general statement of the agreement between our office and the client as to the character of the examination to be undertaken, and usually we have carte blanche in such engagements as involve an examination of financial statements, and a mere reference to that fact would be all that would then be indicated, but if it were a special type of investigation or an examination of financial statements, augmented or supplemented by specific reference to more detailed examination of certain aspects of the business, then, such facts would be shown there.

Q. If there were any limitations on the scope of the audit by agreement with the client, would you expect those to be found in the certificate or in the accountant's report, rather? Distinguish there, if you will, between the steps as the bulletin requires and those which are optional?

A. The certificate should indicate limitations contained in the audit engagement only if such limitations in the opinion of the accountant have made it impossible for him to conduct an examination of the usual scope.

Generally speaking, audit steps required by the bulletin would be in this class whereas audit steps left to the discretion of the accountant may or may not be in this class, depending upon the circumstances in the individual case.

The EXAMINER. We will take a 5-minute recess.
(Whereupon a short recess was taken.)

AFTER RECESS

Q. (By Mr. WERTZ.) Mr. Stempf, you mentioned a few moments ago an audit memorandum. Is that an internal memorandum for yourselves, or is that something which goes to the client and is also signed by them?

A. That is a purely internal memorandum. We rarely have any exchange of written agreements between our offices and the clients concerning the arrangements on an engagement.

Q. It might be general correspondence?

A. General correspondence and usually based primarily upon oral agreement.

Q. Would you include in that internal audit memorandum, an indication of any steps in audit procedure which were omitted by agreement with the client?

A. Yes, we would. Primarily for the purpose of a reminder to those in charge of the engagement that this thing is to be watched to assure ourselves that in spite of such limitation we may do sufficient work to satisfy ourselves and to enable us to render the unqualified report.

Q. When you put one of those in the engagement, you have in mind there that the omission of that step would not hamper you in satisfying yourselves that these statements were satisfactory?

A. I think that in nine cases out of ten that is true. We have relatively few, none that I could name off-hand, cases in which we have definite limitations which we feel should not be there in order to enable us to give an unqualified report.

Q. Now, turning again to the certificate, Mr. Stempf, would you indicate in there the language which states that there has been no material change either in accounting principles followed or in the manner of their application as compared with the previous period? That's on page 41.

A. The words—

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

Which must, of course, be read in connection with note 5, as stated in the bulletin, which reads as follows:

This certificate is appropriate only if the accounting for the year is consistent in basis with that for the preceding year.

Q. That note would not appear in connection with the certificate in the published statement?

A. We have never used it in connection with the certificate.

Q. Do you think it—

A. Directly, although I have—we have substituted the phrase, "consistent with the preceding year," in lieu of the phraseology included in the standard form.

Q. I take it you feel that is a desirable step?

A. I feel it would be an improvement.

Q. Do you make any—customarily make any change in this form of certificate so as to indicate in some way that you have satisfied yourselves as to the scope of the audit work you have done?

A. We have been very loath to make any change in the standard form of report for fear that we, and many others, doing the same thing, might result in the same chaotic conditions that existed 12 or 15 years ago, when there was the greatest possible variety of reports.

We feel that strict adherence to the standard form, with a clear understanding that it is based upon the bulletin, is far better. I have in some cases, substituted a phrase in the scope section reading somewhat as follows:

In the manner and to the extent considered necessary to satisfy ourselves with some appended words which, I think, clearly conveys the idea that we have done all that we consider necessary to enable us to render the unqualified report.

Q. That is what I had in mind. Now, looking at the bottom of page 40 in the introduction to the accountant's report, indicates that language may be included in the report or in the statements for at least three purposes; that is, to be merely informative, to indicate a limitation on the scope of the audit, or to indicate a dissent from the practices followed by the company.

How is the difference in purpose of the language to be determined by the reader?

A. Ideally, of course, the language should be so clear that there would be no misunderstanding. Where dissent is intended to be

indicated, the words "except for" or "with the exception of" are being more generally adopted.

Q. And those appear in which paragraph of the opinion?

A. They would appear in the opinion paragraph of the report.

Q. And do you feel that language included in the scope section operates as a qualification?

A. Opinion varies on that question. Personally, I believe that it is more appropriately placed in the opinion section than in the scope section.

Q. I had in mind there the phrase in the second section based upon the above examination. How about similar language included in the body of the statements, or footnotes thereto?

A. I think I made the statement previously that I look upon the statements themselves, all descriptions of items, footnotes and accompanying explanations as representations of the issuer, separate and apart from the accountant's report but in the aggregate representing those things necessary for the disclosure of material facts which, in his opinion, enable him to render his unqualified report. If they are intended as comments of the auditor, I think they are misplaced if they are any place other than the accountant's report.

Q. To take a specific example:

We have accepted certificates from responsible officials of the company as to quality, quantity, and condition of inventory.

If the company placed that in the statements with your approval, would that indicate or would you put that in there to indicate a qualification on your part in the statement or footnotes thereto?

A. In spite of my preference, I think it is quite evident and quite clear that the purpose of making that statement in the body of the financial statement itself was to imply an explanation, at least, on the part of the accountant who signs the report.

Q. In your own practice would you intend to distinguish cases where you put language of that type in the scope paragraph as compared to places where you put it in the opinion paragraph? I am just trying to orient your thoughts.

A. Any comment made by the accountant, if coupled with the words "excepting for" or similar language, and if placed in the opinion section, definitely intends a qualification. If those qualifying words are excluded and the comment appears elsewhere in the accountant's report, it is intended as an explanation.

VII. GENERAL SUGGESTIONS AND COMMENT

Q. Thank you. A suggestion has been made, Mr. Stempf, that corporations should rotate the firm of auditors at frequent intervals. Have you any opinion as to the desirability of such a practice?

A. I have a definite opinion on that subject. The adoption of such a suggestion, in my opinion, would be undesirable from the point of view of the cost and convenience. It would be a very expensive procedure for the company, because when a change in auditors is made it is necessary for the new auditors to review many phases of the history of the company in order to be able to form an opinion as to the financial statements.

I refer specifically to such matters as the certificate of incorporation and amendments thereto, minutes of the meetings of boards of directors and stockholders, mortgage indentures, leases, long-term contracts for purchases and sales of products, as well as the historical cost of the acquisition of the company's properties. The latter is required in order to determine the fairness of stating the investment in fixed assets and of determining the adequacy of the depreciation charge.

In addition, it should be borne in mind that the new auditor would be under the necessity not only of examining the balance sheet at the end of the year but also of examining the balance sheet at the beginning of the year because unless that balance sheet clearly stated the financial condition, the profit and loss figures for the year, as a whole, would require modification.

Entirely apart from the element of cost, there is the question of convenience to the company. An auditor who is making an examination for the first time is not in as good a position as one who has been employed for many years to render advice on collateral subjects, such as the accounting system, finances, and taxes. It is true that there might be some gain from a possible change in approach on the part of the new auditor.

In our own practice, we take several steps to insure a continuing questioning mind. The contents of audit programs, as a whole, are constantly being reviewed by the partners and supervisors. Important cases which arise in any audits are discussed among several partners and as already indicated, the work is so assigned to the supervisors that each supervisor is in contact with a number of partners. In this manner there is a constant interchange of ideas within the organization so that the client has the benefit of the experience of the group as a whole.

The gain from the possible change of viewpoint of new auditors, therefore, is not likely to be as complete as it may first seem. It is my opinion that the possible advantage is more than offset by the disadvantages enumerated.

Q. Is it customary for your firm to send copies of your reports to the directors directly in advance of their meeting, particularly where you render a long form report? Do you attend those meetings yourselves?

A. Our firm seldom sends to the directors in advance of the meeting copies of the annual financial statement for publication. Such a step might be a desirable one, nor is it customary for a member of our firm to appear at board meetings, although there are many cases in which this practice has been adopted in recent years.

It is my opinion that this step also would be a desirable one.

Q. How about the stockholders' meetings?

A. The same is true of stockholders' meetings. I personally have attended a few.

Q. On that general question, Mr. Stempf, do you have any thought as to the relative desirability of officer-directors as opposed to outside directors, that is, directors who are not also engaged as officers?

A. Will you repeat the question?

Q. Do you have any opinion as to the relative desirability of officer-directors as compared with directors who are not officers?

A. I think we need representation of both on the board. I think it is highly desirable that both types be represented; ideally, I think that sooner or later in this country we should come around to have on our boards of directors many more men who have retired from active operation, but who have a lot of experience behind them and who have the time and ability and willingness to consider deliberately the type of things which come before boards of directors.

I think that our boards would be strengthened by having more men of mature age on them at the present time.

Q. Referring back to one of your earlier answers as to the appointment of auditors by directors, would you think that the appointing of auditors should be by employee-directors or outside directors?

A. I have no fixed opinion on that subject. I think that both classes of directors would bring some knowledge and experience to bear in making such a selection. From the standpoint of the interest of stockholders as clearly apart from those of management, it is perfectly clear that the purpose of appointing accountants through a committee of nonmanagement directors would, to a degree, protect the interests of stockholders as such and as distinguished from management, but quite frankly I don't see the merit of that viewpoint at all.

Q. I think you have stated earlier that it is becoming less customary for you to render a long form audit report. Do you feel that that practice of rendering a long form report is an advisable comment on various significant changes during the year, and do you think also that some comment of that type should be included in published statements?

A. The annual reports now sent to stockholders in many cases are already quite voluminous. I doubt whether much would be gained by making them any more elaborate. For the stockholder who is well versed in figures and who requires more detailed information, the reports to the Securities and Exchange Commission are available.

Q. How about the reports to directors? Do you think that a long form report is a desirable feature there?

A. It has been my observation that it is quite usual for boards of well organized companies to review in some detail monthly reports of that character prepared in the comptroller's department and that they get all of the analytical detail of that character which they may require more efficiently, more expeditiously, less expensively prepared for them. In making that statement I am speaking against my selfish interests, and I am quite willing to undertake that type of work any time they want it done.

Q. I have in mind particularly the value of an independent point of view, not only your being outside of the company, but also having a wider variety of practice.

A. I sincerely doubt the value of that independent viewpoint from the standpoint of management considering its own operations.

Q. Now, coming to the natural business year, I think that you indicated that you actively urged its adoption earlier in the day. Could you indicate some of the advantages to the auditing problems which would result from the adoption of the natural business year?

A. We do actively urge the adoption of a natural business year and have succeeded in a number of cases in having our clients change

to such years. Most often, however, we are met with the reply that such a large percentage of the companies use the calendar year that to change into a fiscal year would result in becoming an exception to the general rule. It is clear that a substantial reduction of peak season concentration could be effected by the adoption of the natural business year. It would enable the auditor to reduce the size of the temporary staff, to carry on the field work with experienced men, and consequently ultimately reduce the cost of audits.

Q. Now, speaking generally, taking present-day audit procedure as a whole, would you say that it is mostly concerned with determining that generally accepted accounting principles have been followed in the accounting records of the company?

A. Present-day accounting and auditing procedure is concerned with a great many other matters. If the question, however, were limited to the examination of financial statements of listed companies for the purpose of the annual report to be sent to stockholders, it would be correct to say that the chief function of the audit is to determine that the financial statements are fairly stated based upon the consistent application of generally accepted accounting principles and conventions.

Q. Taking the balance sheet and income statement, would you indicate briefly the items therein which your examination procedure verifies to your own satisfaction by tests that are independent of the accounting records of the company, and, of course, information furnished by its employees?

A. Cash in bank is primarily verified by confirmation although augmented by tests of transactions during the year.

Securities or other assets, if held by custodians, are similarly confirmed. In a continuing examination balances of capital assets at the beginning of the year afford the starting point and the examination relates only to changes within the year.

Similarly, we rely upon confirmation of insurance agencies, primarily relative to coverage and prepaid premiums. We rely upon trustees or other agencies for confirmation of outstanding balances of fixed debts. The same applies to outstanding capital stock regarding which confirmations are obtained from registrars and transfer agents.

As to items appearing in the income statement, royalties receivable or payable, are usually subjected to confirmation as are also rents and related expenses. Similarly, sales through consignees are corroborated primarily by confirmations. These are not all embracing, but are indicative of the character of items independently substantiated.

In all of these cases also such independent substantiation is integrated and reconciled with the client's records.

Q. Now, looking again at the form of accountant's report, the second paragraph states that in the auditor's opinion based upon his examination, the statements fairly present the position of the company and the result of its operations.

When you or your firm 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 operations?

A. We mean that the examination has been at least as extensive as that provided for in the bulletin, and as applicable to the specific case, and that we have undertaken such work as may have been necessary to satisfy ourselves that the representations of management have been fairly stated.

Q. And you mean by that, satisfy yourselves as expert accountants?

A. Correct.

Q. Have you any suggestions or comments that you would like to introduce at this time, Mr. Stempf?

A. I prepared a résumé of the more vital recommendations that I have made with some additional comments which I should like to read into the record:

In considering the effectiveness as well as the limitations of examinations of financial statements, I think it well to point out the importance of continued reliance on internal control and the related application of sampling and testing as contemplated in the bulletin.

The evolution of auditing practices has relied upon the essential honesty of the management. A system of financial examinations designed to satisfy the needs of publicly held corporations necessarily seeks to provide safeguards commensurate with the hazards at a cost reasonably within the limits of prudent management.

It is obvious that added protection could be afforded at additional cost and selfish motives might well advocate such extension. I concur in the statement often made by members of the profession, however, that what is not good for the client is likewise not to the ultimate advantage of the professional man.

I think the public interest requires a continuance of a type of examination which provides reasonable protection under normal circumstances as has been demonstrated adequately in the past. This precludes detailed examinations and advocates the use of sampling and testing.

On the other hand, it follows that the auditor's work does not follow the continuous path of recorded transactions, but on the contrary the auditor's course crosses and recrosses the path of recorded transactions. If the path be irregular, suspicion may be aroused. If the path be muddy, the inferences to be drawn become rather obvious, but if the path be scientifically built and particularly if its irregularities be screened with shrubbery and flowers, it is still likely that some of the irregularities will be found by the auditor who crosses and recrosses the path. But it is also probable that in so doing he may overlook or fail to encounter some of these irregularities which may in fact be the most vital.

It should be apparent to everyone also that the element of time entirely aside from cost is likewise of major importance. The obvious objective of all concerned is to obtain the financial statements as early as may be reasonably possible after the close of the fiscal year.

More detailed examinations would necessarily involve more time and thereby delay the issuance of reports. I believe that every effort should be made to foster the adoption of natural business years. At the base of all our financial reporting lie the accounting and financial records of business. These records must be honestly and capably maintained, requiring constant vigilant supervision of a competent executive commonly called the comptroller, whose functions should be entirely di-

forced from that of the disbursing officer, the treasurer, and should be independent of the direction or control of other functions of management.

In short, the comptroller should be responsible directly to the board of directors, subject to dismissal only by that body; he should attend and report directly at board meetings. As the chief accounting officer of the company, his position should be created preferably by law as are those of other officers with the provision in corporations over a given size, that the position should be filled by one who has no other functional duties incompatible with those of comptroller.

It should be the duty of comptroller to devise adequate methods of internal control and to see to it that such methods are effectively maintained.

Were this brought about in companies whose securities are publicly held, reliance upon internal control would be fully justified.

The work of external auditors would be expedited through the many preparatory steps which might be taken by the comptroller to expedite the work of the external auditor in marshalling and summarizing the evidence supporting transactions and required for their interpretation and corroboration by the independent public accountants.

The work of the internal auditor may not be substituted for the work which external auditors must do to satisfy themselves concerning the effectiveness of internal control and in support of recorded transactions but all the evidence which the comptroller may produce to support his representations will have a material bearing upon the extent of the related work undertaken by the independent public accountants.

The viewpoint of the comptroller and of the public accountant presenting financial statements are almost identical in purpose, namely, a fair disclosure of all material facts relating to the financial position and results of operations of the business. The comptroller's approach differs from that of the public accountant only to the extent that being on the job the year round, he has the opportunity of interpreting transactions as they arise whereas the external auditor passes upon everything in retrospect in connection with the annual financial examination.

It may well be repeated, therefore, that the essence of cooperation between the comptroller and the public accountant lies in the degree to which the comptroller marshals the fact to assist the external auditor in his work. It seems to me that this is an objective highly to be desired and which would tend significantly to improve financial reporting.

I have previously referred to the matter of appointing external auditors, and I wish to repeat that it is my opinion that it would be very desirable to have auditors appointed by the board of directors with the approval of the stockholders at the beginning of the year and to have the relationship between the auditor and the directors made a closer one. Access to records and contacts with directors throughout the year would make the auditor's work more effective.

The directors should understand the scope of examinations and should be in a position to discuss any items with the auditor which seem to require discussion. None of these recommendations afford

a panacea but each of them would enable the independent public accountants the better to fulfill the functions of that office.

(Discussion off the record.)

The WITNESS. In the answers to the questions which qualified me, I referred to my position as acting chairman of the New York State Society. I think it should be clear on the record that all of my answers to questions today reflect my personal opinions and to some extent the opinions of my partners and associates but in no measure whatever reflect the attitude of the New York State Society or of its committees that have these subjects under consideration at the present time.

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

Mr. HENDERSON. No questions.

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

We will adjourn to tomorrow at 10 o'clock a. m.

(Whereupon the hearing was adjourned until 10 o'clock a. m., February 24, 1939.)