

Q. And do you examine each individual account in connection with your aging schedule?

A. We might not necessarily do it ourselves. In the large companies the credit departments, or the receivable departments, keep fairly good records of aging balances for their own credit men.

We frequently would test—or frequently would test back—check back those agings at the same time we were checking back the trial balances.

Q. I think a moment ago you indicated you did not place much confidence in the negative confirmation of receivables. Would you indicate your reasoning there?

A. In the few instances that we have tried negative confirmations, I do not recall hardly any replies whatever. In other words, unless you ask some one to take a positive step in doing something, it seems to me that human nature is likely to take no action at all. In theory, if an account were fictitious, such a confirmation would put the customer on his guard and he would probably write you.

Q. Would he not write you if it were twice as much as it should be?

A. Theoretically, yes; but we haven't had any experience—results from this whatever.

Q. Maybe half as much?

A. Maybe.

Q. Did you have any indication in those cases that the customer should have replied? I mean, at a later date.

A. If I understand your question right, no.

Q. That is, what I had in mind is that you say that you did not get any responses from them. That might be due to the fact that they were all correct. Did you have any indication that they were not correct?

A. In our experience, no. On the other hand, from a report standpoint, it is dangerous to assume they are correct because they do not say they aren't.

Q. Now, turning to notes receivable for a moment. If you determine to make a confirmation of open accounts, would that control your decision as to whether there should be made a confirmation of notes receivable growing out of open accounts?

A. Where you have the matter of accounts which have been converted to notes receivable, it ordinarily is a case of difficulty on the part of the customer in making payment. Therefore, you have, in effect, an extended account by taking the aging back to the subsequent account itself.

If you have a question in mind brought about by this condition, and we have confirmed notes but haven't confirmed accounts, particularly where a period of statute of limitations might be running, where you might want to be sure in some instance where the statute has run but that the customer has acknowledged the debt.

Q. Generally speaking, between notes receivable and accounts receivable, do the same considerations as to confirmation apply?

A. In the circumstance you mentioned; yes. On the other hand, I can think of cases where clients of ours sell their products entirely by notes over extended periods of 2, 3, 4, 5 years, payable monthly. Depending on the laws of the various States, you have either a conditional sale or possibly some other legal control of that article

until it has been finally paid for, so that those conditions might be somewhat different from the situation you mentioned of notes growing out of accounts.

Q. Would the same considerations apply there as you have indicated would apply to the confirmation of receivables?

A. Not necessarily. There you have evidence of ownership, title hasn't passed. If the notes are being currently collected, ordinarily it is done through banks themselves. You wouldn't be so much inclined to want to confirm.

D. INVENTORIES

Q. Now, turning to inventories, Mr. Mathieson. In your opinion, is an accountant responsible for pricing the inventory in accordance with generally accepted accounting principles?

A. Technically, the accountant doesn't price them. I think he is responsible to see that it has been priced in accordance with generally accepted accounting principles.

Q. Now, if you are employing an inventory pricing method with cost or market, whichever is lower, what does the term market mean, in your opinion?

A. Market would mean the price, or value, at which similar quantities could be replaced in customary purchase quantities on the open market.

Q. That is, replacement market in customary quantities?

A. Customary quantities and customary places or market maybe if your client is manufacturing a product, that with respect to his finished product it is not valued at more than his existing selling price, less the cost of selling, administration, and possibly discounts and other items that may be incurred in the disposing of the merchandise.

Q. How do you determine what that market price is in the case of replacement market you mentioned?

A. You have available quotations, accepted periodicals, newspapers, you have from your knowledge of the business itself what they are buying similar goods for or selling similar goods for at the present time. It is just as necessary to value raw material on what they can replace it for as it is to value their finished material and what the build-up cost would be and the market would be for that.

Q. How can you determine whether the market price is applicable as to the quantities that you have mentioned?

A. We frequently do it by confirmation with suppliers, particularly in commodities—particularly in such commodities as cotton, wool, silk, and you also have your quoted prices in trade journals.

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

A. Well, as a rule they are on basic rates. The basic rates may be different from those, but, generally speaking, in dollar value the same. The fact—if you don't have one grade you can sell another to buy it without any relative loss of value.

Q. How about the question of quantities, whether those quotations refer to quantities such as normally purchased by the company?

A. I should think it would apply to quantities which are customarily dealt in and have a quotation given covering them. That is why I said in quantities customarily purchased.

Q. You can see to it that those quotations referred to purchases and sales in the quantities customary to your clients?

A. That's right.

Q. What procedure do you follow, Mr. Mathieson, in determining that goods held or shipped by the company on consignment are properly treated in inventory?

A. Well, today that is not so much a factor as it used to be. The Robinson and Patman Act has reduced the old idea of consignment inventories, therefore, we don't have very many of them.

If there are consignment inventories, you verify them by confirmation with the consignees.

Q. And also the consignors?

A. Well, the consignor would be your client and you would see that those goods had been shipped and see that they were not priced at selling price but at inventory or at some amount probably below the inventory, if they had been in the consignee's hands for some time, indicating inability to move them.

Q. Are you speaking now of goods held by the client on consignment from someone else, or goods which he has shipped to someone else?

A. I am speaking of goods which he has shipped to someone else on consignment.

Q. You would not confirm from that consignee?

A. We would.

Q. How about confirming from someone who has shipped goods to you to hold on consignment?

A. That is a little more difficult to find that this condition exists. If it is customary in the trade to have consigned merchandise, or sometimes they now change the name from consignment to have it "located at your plant for distribution." Then, you confirm with the consignor.

Q. If you found the company had been in the habit of dealing with certain people on the basis of consignments, either to or from the consignee, but the records showed at the year-end they had no goods out or held any goods on consignment, would you nevertheless confirm with those people?

A. It would be our custom to confirm with them. Had there been activity within the last 6 months of the year we would confirm.

Q. Irrespective of what the record shows at the present time?

A. That's right.

Q. And do you make any other tests to determine that the inventory that is on hand is actually owned by the company?

A. We require a certificate from either the president or treasurer that that property, or, rather, the inventory or other property, is free of debt or free of lien, or such and such liens exist. In the inventory certificate which we get, we also require the statement that the inventory is owned by the company without any liens attached to it.

Q. Do you make any other test as to that?

A. Our other tests would be in the normal examination, seeing your purchase invoices insofar as inventory quantities at the end of the year are concerned and investigate with respect to particularly

raw products, when they were bought and that the liability therefor has been entered into the accounts payable at the end of the period.

Q. What procedures do you follow to determine that they have not included in sales, goods which are shipped subsequent to the close of the period and the converse case?

A. It is more the converse case to be sure that your inventory does not include items which are included in the sales records. That is done again by a test check of sales invoices, depending upon the circumstances, for a period of possibly a few days to a few weeks to see that items that can be specifically identified in the inventory are included in subsequent sales and also a review of sales of the preceding days or weeks, as the case might be, to be sure that items included in the inventory are not included back in those sales also.

Q. I think you indicated you try to identify particular goods in that connection. Do you make any test checks of the records?

A. In a manufacturing industry manufacturing durable goods, it is possible to identify specific machines, you are building machines or something of that kind.

Q. If that isn't possible, what do you do?

A. One illustration I have in mind, you take the cut-off period at the end of the year, and from the production records determine where they stood, what the situation with regard to production was, and trace from there on. I have in mind, particularly, radios which bear a serial number and in their control and in their records they indicate these serial numbers from dates, billing, and to whom they were shipped. The same thing is true of refrigerators or something of that kind.

You have a fairly definite means of finding out the inventory is not also in sales.

Q. Now, if you can't identify particular goods in that fashion, what do you do?

A. It depends on the general test and investigation that you are going to make of the records to see that there is nothing unusual in inventory comparison of like quantities in like periods.

Q. What records do you examine in that connection?

A. We examine the inventory at the end of a particular accounting period with the inventory of a preceding period or possibly even two preceding periods.

Q. Would you examine the shipping records to determine dates and so forth?

A. Yes. In the investigation you would see that in your cut-off period. You wouldn't necessarily go into too much investigation of shipping records.

Q. Would you make any distinction in cases where the goods are not held at the plant, but are held in a warehouse or place not under the control of the company?

A. You mean goods manufactured and produced by the company?

Q. Yes; but held in a warehouse not under its control.

A. Well, the warehouse—we make a distinction in the fact that, if possible, we obtain confirmation of the warehouse quantities, bonded warehouse.

Q. I am speaking now of the cut-off question, as to whether they actually were shipped within one period.

A. The investigation of the reports rendered by the warehouse that would become the basis for billing.

Q. That is, you would apply the same test to the warehouse records as you would the company's records?

A. That is right. Or even more so because they are outside the walls of the company itself and probably under the control of someone not definitely under the daily operation routine, so you want to be sure what was in the warehouse was reported as having been shipped or not, as the case may be.

Q. Do you employ comptometer operators in verifying footings and extensions of inventories?

A. We do on large inventories.

Q. Do you see any undesirable features in that practice?

A. No. The desirable feature is in the saving of time, the mechanical work is done by girl operators, is done so much more quickly than our men might do it, that it seems the sensible thing to do.

Q. Now, what inquiries and tests is it customary for you to make to determine that purchase invoices or stock included in inventory have actually been entered on the books in the reverse case?

A. The practice requires the examination of invoices of a subsequent period between the close of the year and the date of our audit to see that invoices dated—to see that from the invoice dates therein entered, that they shouldn't apply back, investigate receiving department records to find out what might have been received, particularly in major quantities and the date they were received, be sure that quantities coming in before the end of the year are also covered by obligations or liabilities properly set up on the books.

Sometimes to a confirmation with the vendors of the correctness of their accounts. At least the examination of their statements that are available.

Q. What evidence do you rely upon to establish that all the stock received has actually been included in the inventories, that the client hasn't left out a bill of some stock and also the invoice?

A. Again depending upon the size of the business. Inventory records as a rule—stock records of some sort are available. We would test check those records to see that quantities shown are first of all in accordance with the inventories and that an adjustment in the physical inventory has been taken or made at the same time to see that current purchases have been entered, also, as the reverse, verification of the payables.

Q. Now, if you followed the procedures as to inventories which are outlined in the bulletin and have satisfactorily completed them, do you include in your certificate, or report, or in the statements, any qualification as to the quantity, quality, and condition of the inventory?

A. Generally, yes. On the theory that as accountants we are not qualified to certify as to quality, particularly. Seldom as to quantity, unless you had actually supervised the taking of the inventory itself.

Q. Is it your practice to supervise the taking of inventory or to make any sort of spot checks?

A. We endeavor to do as much of that as we can, believing the best way to verify a thing is to see it. It may be possible to spot check.

If you are going to supervise, then plans would be made with the client in advance, to outline the plans under which the inventory was to be taken. We frequently make, and do it often, spot tests of the quantity shown at the end of the year.

Q. Could you give any indication as to the additional expense incurred by following that procedure of supervising the inventory or spot-checking?

A. In supervising the inventory which would include the planning of taking it, having your men there to test check counts, weights, seeing the quantities, I would say it would probably increase the cost, maybe 20 percent.

Spot checking would not be particularly expensive, because a man in a short period, or men in a short period, depending upon the size of the inventory and how it is kept and where it is located, can do a lot in a few days' time.

Q. Could you give any indication of how much that would increase the audit costs?

A. Well, I would say——

Q. Would it be more or less?

A. In the bigger companies, it would be more. The cost would be increased by more than, possibly, 10 percent.

Q. Now, if you had made that sort of a test, that is, supervised the taking of the inventory or spot checked it, did you include the qualification you mentioned a moment ago?

A. We would include the qualification with respect to quality.

Q. And condition?

A. And condition. On the other hand, in the investigation of inventory which we make, we endeavor to determine from, if not the quality, but from the records how it is moving, whether or not there is obsolescence, whether the styles are current, whether the quantities are properly balanced so that sales can be affected from it.

Q. But as to that you would still include the qualification as to quality and condition?

A. Well, in answer to your question there, we don't use the condensed balance sheet and accountant's certificate any more often than we can help. In our complete reports, we would outline the procedures which we followed to verify the inventory.

Our qualification would probably be reduced on a condensed and certified balance sheet had we test-checked or had we supervised. Probably had we supervised the qualification would be out except as to quality.

Q. Do you feel that the inclusion of such a qualification relieves you of making any of these tests that are referred to in item 3 on page 18?

A. No. We make tests anyhow.

Q. What tests do you feel that that sentence contemplates? Is it your understanding that the sentence contemplates the type of physical tests that you have mentioned, spot checking and so forth?

A. That test—the sentence would indicate to me that they would see that the procedures—no; it is not.

Q. What test do you think that has in mind?

A. In my opinion the sentence referred to means that we have tested the method used by the taking, in taking the inventory and in pricing the inventory and in determining whether or not stock is

salable or properly balanced, and that the test would include verification of prices, of extensions and computations, footings and probably at least a test check back to the original inventory records themselves.

Q. Do you review the methods that the client has followed in taking the inventory if you don't actually supervise it?

A. Yes.

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

A. Proper planning in advance on the part of the client to see that the inventory as taken is verified by some other part of the client's own organization, preferably, for instance, in manufacturing, that the quantities are counted by the department members and recounted or retested at least by independent employees, that proper arrangement is made to see that the records of these inventories on serially numbered cards or sheets are returned to a central source for compilation, price, and extension.

Q. You said recounted, I believe, by a second group?

A. Yes.

Q. Would the count of the first group be available to them at the time they were making their count?

A. Generally; yes. The second group would be more of a verification of the first group. If the quantity appeared to be correct, they would accept it.

If there was any indication in their minds that it wasn't, they would recount it.

Q. How do you determine that this check on quantities is observed?

A. Usually in the department where the count is taken, by discussing with that part of the management responsible for production or material control—what has been done; generally, by further discussion with the superintendents of departments where larger quantities may be kept. By going through the plant and seeing the inventory yourself, by seeing that in general proportion that inventories are as they should be.

Q. You say going through the plant and making general observation of this. You have in mind there making the physical steps that you were mentioning?

A. No; I don't have that in mind in that case. Generally speaking, a plant is organized to produce in certain quantities and volumes, if inventories do appear greater in proportion than an auditor would expect to find, you might ask to see them if in the normal course of production merchandise as made was shipped, and if you found that the flow of the material was in proportion to the production and sales itself, you have a fairly correct view of the taking of the inventory.

Q. Going back to determining what procedure was actually followed as contrasted with what the proposed procedure was, would you make inquiries of some of the people who were actually engaged in the physical labor of taking the inventory?

A. Not employees themselves. We would with respect to foremen or supervisors. In each case it would depend, I think, upon what knowledge we had of the plant conditions and what work we were doing for the company, possibly what contacts we might have had throughout the year, what the cost system might be and what controls might be effected by that.

Q. If you determine that methods followed by the plant were unsatisfactory to you, what position would you take?

A. If the methods followed were unsatisfactory in that we believe that a distorted value was obtained—this is a hypothetical answer—we might request that another inventory be taken or an adjustment be made to the inventory to bring it into more conformity with what it should be, according to the circumstances.

I presume theoretically we might refuse to give a report, but I have not had that experience.

Q. When you are appraising the integrity and accuracy of inventory quantities, condition, and quality, do you give any weight to the condition of the shipping, receiving, and stockkeeping records and the methods employed?

A. Yes; if I understand you correctly, the effectiveness of control in the records that are kept indicating the flow of the material itself is a very important part of our investigation and verification.

Q. Is the independence of this function important in that connection?

A. Yes, very much so.

Q. Is it your practice to make any over-all tests of the reasonableness of inventory quantities by comparison, say, with warehouse capacities, average consumption, insurance payments, tax payments, etc.?

A. It is definitely our practice to make a comparison on an over-all basis considering the factors you mentioned and possibly to a larger or smaller extent individual ones, but from a common-sense application of whether the inventory appears to be in line with what you expect, considering the volume of business at the present time and what you expect as to the physical capacity to support an inventory.

If you have a company manufacturing a product that in a certain state in a number of units, it would be hard to store, let us say, and you found those units to be greater than that, you should raise a question as to the correctness of the inventory.

Q. How do you determine what over-all tests to apply?

A. That is hard to put in words. We would compare an inventory of the current period with inventories of prior periods. We would have that inventory segregated into its various divisions to see what variations there were with respect to those divisions in the period.

We would determine comparative turnovers of inventory with respect to sales, and taking general conditions into consideration use all of them in determining whether we thought the inventory values were in line or weren't. You can also determine from the company records of production sales and purchases what should or should not be there.

Q. Have you any test in mind that you use that will indicate it here?

A. I think the questions you asked cover it pretty well.

Q. Do you utilize the gross profits test?

A. Where you can have a common denominator of measurements; yes. If the company is manufacturing or dealing in one commodity and there is a real comparison between periods, I think the gross

profits test is good. If you have a number of products where any line or any particular one varies in sales, there it is harder to follow, but we do use a gross profits test.

Q. Do you use it on a departmental basis?

A. If we can get the figures broken down on that basis, yes, because there it has a very definite effect.

Q. What evidence do you customarily rely upon in determining the quantity of inventory in outside warehouses?

A. Confirmations, examinations of records indicating the material put into the warehouse, and the material withdrawn as compared with the reasons for putting it there or the sales made from it, as the case may be.

Q. Does that apply also to inventories held by the vendor or held in the vendors' warehouses?

A. Do you mean in that instance, where the client has paid for the inventories the vendor has? Are you distinguishing there between goods which the client has not paid for?

Q. Treat them both, if you will.

A. In my experience I do not recall any instances where any appreciable quantity of merchandise was ever held by the vendor after it had been paid for. He may have commitments which the vendor is to fill, ordinarily title hasn't passed. Customarily, when title has passed, the transfer is made to sources controlled by the client himself.

Q. Would the procedures which you follow disclose whether or not there had been misappropriation of the merchandise held in outside warehouses, that is, the acceptance of confirmations?

A. In general it should if the outside warehouse is independent and as is customary, they report withdrawals or can only make withdrawals on proper authorization. The confirmation of the quantities there should disclose any withdrawals made for which sales were not reported.

Q. Would it disclose misappropriation by the warehousemen?

A. No, it wouldn't because if he had misappropriated he would confirm what should be there rather than what shows there.

Q. And if it was held by the vendor, I presume the same would be true?

A. Yes.

Q. Do you make any other tests of quality, quantity and condition of the inventories than those we have been discussing?

A. I have already mentioned the question of turn-over, style obsolescence, one very definite test we make is the question of balance where you frequently find in production of the companies that inventory may be in quantities greater in certain parts than it is in others, which would materially reduce the value of the parts where they have an excess unless they are in a position to manufacture the others and unless the demand in the trade is for the product that those parts can be used in.

Q. Do you apply any sort of similar tests to nonmanufacturing companies?

A. Style is a factor in almost every business. That brings up the question of obsolescence. We try to apply the similar test to be sure

that merchandise on hand is salable. If you are in a department store and they have at the end of the year a large stock of Christmas toys, you are faced either with the matter of carrying them for another year or possibly a sell-out at a sacrifice price to somebody who will carry them. Therefore, you investigate inventories to determine classifications of that kind.

Q. Looking to the future, Mr. Mathieson, what procedures do you think auditors should follow in verifying the quantity, quality and condition of inventories? What is your feeling on that?

A. I think the auditor has a responsibility to determine from records and from available sources what the problems of the business are and what the relationship of the inventory is with respect to its valuation. I don't think we are equipped to certify as to the correctness of technical quality, technical conditions, nor do I think we are equipped to verify physical quantities where the question of reliance or faith on records, or the nonreliance of them would be a factor.

The verification that the accountant may make in my opinion can be of real value in the preparation of a statement.

Q. I am not quite clear as to what you had in mind by reliance on records or nonreliance on them in the case of verifying physical quantities.

A. I meant by that if, for illustration, you have bales of wool that are piled in a company's warehouse preparatory to processing. There may be quite a cubical space involved, unless you could pull out each bale and weigh it to see that the quantity was there—I am speaking now from a quantity standpoint, you would have to assume that all bales are of a like weight, which they generally are, and that back under the pile there were still bales of wool and not something else.

So far as the quality is concerned, in no case do I think we are qualified to pass too much on that.

Q. Speaking of the bales of wool, do you feel you are entitled to rely upon the fact that there are—

A. I think we are because of the very way in which it is handled. You would have to have, it seems to me, connivance between a warehouseman and plant superintendent and other workmen and some one in a responsible position who would control cash in order to have anything really out of line, but if we are faced with the fact that there was that connivance, the auditor in my opinion is not in a position to find it in that way.

Q. By—

A. By assuming—what I mean by that is that if we verify the quantities as indicated and those quantities are determined in the customary manner, packages as customarily made up do have in them the contents indicated. Then we can verify quantities in that way.

If those packages had been altered or changed, unless you opened every one, then we couldn't be held responsible for them.

Q. Do you feel that making such physical tests as you can is sufficiently of value that an auditor should undertake to do it?

A. Personally I think it is. I think that it helps also in the general examination in the fact that our men can see what the material the client is using or making looks like. It makes his work much more interesting and much more effective when he sees those material names appearing in the record. He can visualize quantities and quali-

ties and convert in his mind from figures something that is tangible or existing. He can do a better job than if he doesn't know what he is talking about.

Mr. WERNTZ. May we recess until 2:15?

(Thereupon at 12:30 o'clock p. m., a recess was taken until 2:15 o'clock p. m.)

AFTERNOON SESSION

Q. (By Mr. WERNTZ.) Going back to inventories for a moment, Mr. Mathieson, what is your feeling as to the significance of an adequate verification of the inventory?

A. My personal feeling is that the inventory is probably the most, if not—or almost the most, if not the most important item on the balance sheet. Without a good inventory there is no reasonable expectancy of any profit. If it isn't flowing through in a normal manner it will become stagnant or impossible to move. Then the capital of the company is so tied up that either the profits are reduced or something more serious might very well happen from it. Therefore, with the importance of the inventory, insofar as the final statement is concerned, we lay great stress in the verification as much as we can of the inventory values so as to assure ourselves that the indications, both of financial position and of what might be represented by management policies are as they should be, and in forming our opinion of the financial position in the statement we give we emphasize that point very much.

Q. You have in mind there the type of business which would have an inventory as distinguished from service organizations?

A. Oh, yes. Where a product is either being dealt in as a jobber or manufactured and sold.

E. OTHER BALANCE SHEET ITEMS

Q. Now, turning to some of the other items in the balance sheet, referring particularly to item 4 on page 21. How do you determine that amounts capitalized as additions to plant actually represent real additions or improvements?

A. From the book records the fact that the vouchers received for it indicate the type of asset which would be considered as a capital asset, also the type of expansion. We also go a step further to see that those expenditures that are considered plant additions really result in increasing the plant capacity and are not just a replacement of something which previously existed or, in the case of a coal mine, for instance, that additions going back further into the mine which don't increase production certainly don't increase the capital worth.

Q. How do you determine those factors?

A. From production records, from inquiries, from the volume in relationship of the business that the company is actually doing.

Q. Do you make any physical inspection of the plant in that connection?

A. Not generally. Occasionally, yes. As I said before, we make it a requisite part of our examination that the senior and other men when convenient to the plant during the course of the work are

acquainting themselves with what conditions or improvements may have been made, but from the standpoint of the engineering features of it, we wouldn't attempt to verify it necessarily in that way.

Q. Now, as to property that has been abandoned. How do you ascertain that plant units that have been abandoned have actually been removed, or should be removed from the plant account?

A. I don't think we make any attempt to do that. Fully depreciated machinery may, as a matter of actual fact, be still located on the floor of a business. It may be still in use or it may have been shut down temporarily or moved to another location. As long as it is not carried at any value, as long as the productive capacity through the abandonment of that machine has not been particularly affected, I don't see where there is any need to do much with it.

Q. Do you make—do you get a certificate from the management that there is no property which has been abandoned but not written off?

A. As a general rule, no. I think we know from the investigation that we are making, from the contact that you have with the company, from seeing possibly some change in production lines, whether any material change in the plant set-up has been made. If we do find that, then we make further inquiry to establish that the thought back of it was—

Q. (Interposing.) If you find that there is machinery in use which has been fully depreciated, would you make any adjustment?

A. No. I would hesitate to write it back on as a value and as long as it wasn't there, I wouldn't think I would see any reason for putting it there.

Q. Even if it were very significant?

A. That indicates that there had been over-depreciation in the past. Depreciation and obsolescence are considered more or less synonymous. When you speak of over-depreciation in the past with certain items, it is usually counter-balanced by some other factor, machinery, possibly, or where the requirements from a record standpoint there is an indication of further capital expenditure, I would say. If that isn't being made I see no reason why the accountant should make it.

Q. What steps do you take in verifying the allocations of insurance charges between periods?

A. The customary procedure is to examine the insurance policies in force in determining the necessary respective types of coverage, to allocate for future periods that part of the premium which applies to a period subsequent.

Q. Do you utilize the information obtained in that examination for any other purpose?

A. We utilize it, first, to see that plant contents are covered, to see that the necessary compensation, public liability, boiler, other types of insurance generally are acceptable, generally accepted as part of doing the business, are maintained. The policies themselves don't very often analyze values as between inventory and other contents, or buildings themselves. If we have occasion to feel that coverage is not sufficient we would write it in our report.

Q. At page 24, it is suggested that a test examination be made of creditors' monthly statements covering large balances. What is your practice in this connection?

A. We examine customers' statements—

Q. These are creditors' statements, I believe.

A. Creditors' statements. Excuse me. Wherever we possibly can and, as most of the examinations are made after the end of the fiscal year, they are available in the month or 6-week period immediately following that. If we have occasion to feel that liabilities may be greater than the amount set up, we might actually correspond with some of the major creditors to be sure that there are no greater amounts due and to be sure at the same time to what extent commitments may exist.

Q. You would not ordinarily confirm payables unless you had some reason to?

A. We would not ordinarily confirm them.

Q. Now, turning to page 8, in the last paragraph, what is the significance of the statement that approval and entry of vouchers will be made by others than the disbursing officer?

A. Well, the system of internal control, or internal check by which goods are received and the receiving slip passes through in due course is an indication of authenticating quantity of material, merchandise, and purchases evidenced by the vendor's invoice. Those records should be maintained in a separate place from the source that is going to pay them. Otherwise, potential possibility that fictitious invoices might be set up, if controlled under the same responsibility.

Q. Do you feel that is an important point in the system of internal control?

A. It is very definite in the investigation of a system of internal control.

Q. What procedure do you follow in determining the existence of contingent liabilities? What responsibility do you take in that connection?

A. Well, we try from all angles that we can to determine what contingent liabilities may be or what, from the indications of the business activities, might be expected to be. We make it a practice of communicating with the company's counsel, getting from them, where possible, letters stating that—letters advising us of pending suits, or threatened suits and of any contract commitments or guarantees which they may know of. Also from the examination of the minutes and what might be set forth there as having been authorized by the board of directors or respective subsidiary committees of the board and back it up ordinarily with a certificate from one of the top major officers. By that, I mean either the treasurer or the president, because generally speaking they will hesitate to sign something unless they themselves have found out there is not something significant outstanding not on the books.

Q. In that connection, you referred to the minutes. Did you have in mind there the stockholders' or directors' or operating committee minutes or what?

A. All minutes that are available. As a matter of fact too often there are no minutes. The average corporation that isn't bound by

formality, either in size or registration requirements, has about one or two minutes a year, usually confirming what has been done rather than outlining what is to be done.

Q. You do, however, consult those for what they may be worth?

A. We do review the minutes to be sure that anything pertaining to the operation of the company has been properly set forth on the books.

Q. Do you review contracts in connection with the contingent liabilities?

A. That would depend. The question of contingent liabilities where they are represented by forward purchases or forward sales is a direct part of the company's normal business. We wouldn't bother to examine it. Where you have contracts possibly for purchases far ahead of current commitment requirements and there was any question in our mind, I am inclined to think we would consult the attorney rather than depend on the contract, although I think, generally, the accountant is capable of interpreting a contract made in due course.

Q. Do you go over the contracts to see whether there are any that you should get advices on from counsel?

A. In contracts, from my experience, that is something that comes up very seldom. As a rule, American business isn't done by contracting in that manner. Usually an order is placed or an authorization to ship against subsequent instructions or something of that kind.

Q. Now, as to taxes. Do you expect your auditing staff to be familiar with the general nature of all taxes impinging on the particular business?

A. No. As far as being familiar with all taxes, I think it is too much to expect. We do expect them in a business that is faced with excise taxes to be familiar with those requirements. In fact that the liabilities are properly set up.

In respect to the property taxes peculiar to that locality, that they have been paid.

With respect to state taxes as evidenced in Pennsylvania, by capital stock, loans and income taxes, and federal capital stock and income taxes, yes, but other than that I wouldn't say that we would expect each man on the staff to know in detail how to prepare them or what they were or even some of those taxes.

We have a tax department which we use.

Q. Is the question of taxes gone into in connection with each audit?

A. It is, very definitely.

F. PROFIT AND LOSS ITEMS

Q. Now, turning to the profit and loss statement, on page 30, item 1, there is a suggestion that a working profit and loss statement be obtained, or be prepared in as much detail as is readily available. For this purpose to what extent would you utilize statements prepared by the client?

A. In our practice, we use those very infrequently. We prepare our own profit and loss—we prepare our own trial balances as a rule and prepare our own working papers and our own statements.

There are preparations, while technically they may be through the presentation of the company we actually prepare them—the arrangement is our own.

Q. Do you make inquiry to determine whether the client has available monthly statements or budgets?

A. We do.

Q. And do you utilize those if they are available?

A. Where available we do utilize them, particularly to follow their variations and with respect to companies having established budgets to see what actual operations—how actual operations compare with the estimated budget.

Q. When you find variations, what do you do?

A. Finding of variations would determine, ordinarily, the fact that there has been maybe a change in products sold, maybe it is due to reductions in volume or increase in volume. If variations come about in that manner, we will probably satisfy ourselves that that is the fact and do nothing more about it. Where we find variations in unexpected character, we will naturally go into that very much further to find out what brought that about.

Q. In item 3 under sales and cost of sales, there is outlined a procedure for testing allowances to customers for returned merchandise, for claims and rebates. What's the importance of such an analysis? Do you generally make it?

A. We generally make it a very definite point of examination. It has several reasons for existing. The first, possibly, is that in this method you see that theft or petty embezzlement, or even major embezzlement is not covered up by what is termed "returned sales," or allowances or discounts beyond the normal expected amounts. Also from those allowances you get an indication of the value of the customers' accounts. By that I mean how much reserve might be essential to set up for bad debts the trend of collections. You get an opinion if there are major allowances resulting from imperfect or defective materials that have been sold. That is, there is more to come. It serves any number of purposes.

Q. Now, turning to the profit and loss statement, generally. What do you feel to be your responsibility for the proper classification of expenses and income? How do you satisfy yourselves on that?

A. Well, as I stated before, in preparing a profit and loss statement we make it up ourselves to, in our opinion as clearly as possible, to reflect the results of the operations of the business. We attempt to classify production, manufacturing cost, in one group, selling in another, administrative in another, set aside those items which are unusual as affecting particular years and place them where they will be given proper effect without distorting in comparison to other periods.

Q. What procedures do you follow in satisfying yourselves that correct distinctions have been drawn, or do you accept the records of the company on that?

A. From the investigation made and the test checking of 2 or 3 months, or 4 months incidental to the preparation of balance sheet audit, through the balance sheet examination, we have checked pretty carefully the distribution of expenses and the distribution of income so that when we pool together the figures shown by the trial balances

and prepare the annual statements, by that time we are familiar with what is in there and where they do belong.

Q. Do you follow any procedure to determine whether the decision of the company to include a particular item in a particular expense account has been carefully carried out?

A. Not generally. If we find that—in our experience if we find they are distorted, we probably correct them in making our own statements without reference to the company or asking them to change their ledgers. We give them corrected entries at the end to bring their accounts in conformity with our examination.

V. REVIEW OF THE ENGAGEMENT

Q. Now, turning to the review of your working papers. In your practice, who is responsible for drawing together the results in the detailed audit program and preparing the preliminary financial statements?

A. Well, the senior is responsible for seeing that the work required to be done is done, also responsible for putting together the preliminary statements and drafting the preliminary report.

Q. Is it customary for someone in the organization to review the working papers and the statements other than the person who actually prepared them?

A. A partner, yes. Although a partner necessarily might not go over in detail all the working papers. I make it a practice, personally, in many instances to review the working papers with the senior to be sure that the points and notes he has on there have been properly taken care of, or that factors we might consider important beyond the average have been properly gone into.

Q. Is the senior supposed to go over the working papers of the junior in detail?

A. He is supposed, when he gets working papers from the junior, to satisfy himself at that time that they are in order and that the junior in preparing them knows what he has done.

Q. Now, as to the work that the senior does himself, would the partner review that in detail?

A. I don't know how much you mean by detail. The partner would review with him what had been done, but I think would accept the senior's statement of what he said he had done rather than check him up on every little item.

Q. For example, suppose the senior had actually done some of the preparation of working papers in the course of his work on the particular job that might, on another job, be done by a junior. Would there be anyone who would give the senior's working papers the same review that the senior gives to his juniors?

A. If I understand your question correctly, no, because the senior is still responsible for the job and that frequently he might be in the position that he doesn't have enough junior help to do some of the things that you might expect a junior to do. Therefore, he is forced to do some of the manual labor, so to speak, but if he is responsible for it at all, I see no reason for his papers being reviewed in detail. We are taking his opinion in the thing in its major aspects.

Q. Would you consider the review the partner makes is a spot check of the working papers?

A. Possibly. Generally speaking, yes. It would depend upon the client, it would depend on how familiar the senior was with that client's operations, whether he has been a client we have had for some time or whether it was a new one this time. The partner would be more inclined to go into detail to see what the true picture was with a new client or where the senior was new to the work. In other words, cases where the partner may know from previous contact himself in a number of instances, from having done the work himself, there may be less detail review.

Q. Would the partner see to it that the statements as prepared by the senior actually tied into the working papers?

A. No, I wouldn't say so.

Q. Would he review the statement in detail and ask questions based on it?

A. Oh, yes.

Q. And if any questions arose would he go back to the working papers?

A. Yes. At the time the report is reviewed the working papers are available as well as previous year's reports and previous year's working papers so that as items on the report on the balance sheet or profit and loss statements or subsidiary statements are discussed, it is very frequently reference is made to those papers at that time only as in the partner's mind required to get a true picture of what he is talking about.

VI. THE REPORT OR CERTIFICATE

Q. Now, turning to the accountant's report for certificate, Mr. Mathieson, what persons in your firm are authorized to sign a certificate?

A. Only a partner.

Q. Does he draft it?

A. The certificate I think you possibly had in mind would be attached to a condensed balance sheet. We attempt to discourage it in our work as much as possible, and we don't issue very many of them, and that only when they are demanded for credit purposes.

We prefer, and have been possibly fortunate in having our clients give to the banks complete reports rather than a certificate form. Where we do have condensed statements with a certificate, probably the senior would draft the initial draft to be corrected by the partner or it may, if the circumstances are peculiar, be drafted by the partner in discussion with the senior.

Q. In connection with an examination along the lines of this bulletin for the purpose of annual reports to stockholders, or for inclusion in registration statements, would you follow, generally, the form of certificate given on page 41 of the bulletin?

A. Generally speaking, for stockholders or for local banks we would not.

Q. Would your answer differ as to whether the stockholders were management stockholders or nonmanagement stockholders?

A. Where stockholders are management stockholders, there is no reason to give a condensed balance sheet with the certificate. A complete report is given instead. It is only where, possibly, the bank only gets a condensed statement that the question of a certificate

comes in. With respect to registration statements for the S. E. C., we use very much—we use a form very similar in type to the form set forth in the pamphlet.

Q. What, in your opinion, is the proper function of an accountant's certificate or report? What do you intend to do by it?

A. We intend to present—the function of the report or the certificate is to present the accountant's opinion as to what he believes to be the facts after having made examination of the client's records and other pertinent data pertaining to its finances. Basically, it is his opinion and presentation of what he thinks as an expert.

Q. That is the impression you try to convey in your certificate?

A. That is right.

Q. Looking at the form of report, accountant's report, included in this bulletin. Is it your understanding the second sentence of the first paragraph is intended to be a reasonably detailed statement as to the scope of the audit made? That's on page 41.

A. May I have your question again?

(Question read.)

A. Yes.

Q. When you are using a short form certificate of this type, do you generally follow the language of that sentence in describing the scope of the audit?

A. We follow it in the general way, with more specific statements regarding either reservations or definite indications of what we did or didn't do.

Q. What do you do when you use the long form certificate?

A. The long form certificate—

Q. (Continuing.) Or report, I should say.

A. In a report we outline in fairly complete detail what procedures—what methods we come to verify or not to verify as the case may be, of the particular items we are commenting upon, and we would go probably to some length in not only saying what we had done but in saying what the result was we accomplished by doing it.

Q. Do you think that is a preferable method of putting the scope of the audit before the reader of the statement?

A. I do. Much preferable to the short form certificate.

Q. Do you believe that any material omissions from the procedure indicated by the bulletin should be set forth either in the long form or short form certificate to which you referred?

A. Generally, yes. In other words, the bulletin was developed to be a guide of what would be considered good practice.

Now, if some part of that is eliminated for some purpose or other it should be indicated—it should be indicated in the certificate what eliminations have been made. Ordinarily you would expand the procedure set forth in the bulletin rather than limit it.

Q. Would your answer be the same if the reason the step was omitted was that the condition in question was not present?

A. I assume you mean special investigation of a defalcation of that kind, yes.

Q. No; I mean if in some of the procedures inventory was omitted because it was an investment trust, that is, physical inventory.

A. There the type of report would be somewhat different than an industrial or merchandising concern. In an investment trust it is much more possible to examine the assets.

Q. Let us take another case. Assuming a service type of company which has no inventory. Would you fail to repeat in your report, to say that the procedure as to inventories indicated by the bulletin was not followed?

A. No; there it would be self-evident that it was not a factor.

Q. If, however, it was a required step in the bulletin and the condition was present, you would feel that the omission of the step should be given attention in the certificate?

A. Yes; I do.

Q. In making an engagement with a particular client, do you ordinarily reduce that to writing?

A. Very seldom except possibly an informal letter confirming arrangements that have been made for the year after a discussion personally with the client.

Q. Do you prepare any sort of internal memorandum as to the scope of the audit including any restrictions or things not to be done?

A. For submission to the client?

Q. No; for your own staff.

A. For our own use, yes. We several years ago had a mode of procedure which had developed into quite a comprehensive set of questions. We rather felt at that time that what was happening was that we were getting answers to those questions and limiting the inquisitiveness and the like of the man making the examination.

We converted to an index form a plan by which all papers pertaining to the same subject in each client's name contained the same number and in each of these we would indicate the papers you would expect to find in those classifications which we considered to be a reminder to the senior, not telling him what to do but reminding him if he hasn't done all those things in the course of his examination, that possibly there is something more to take up. That is discussed with the senior at the time he is instructed on the work to do and additions made to date or indications made on it of particular items to be covered by him.

Q. Would you say that in the certificate there should be an indication of any limitations of the scope of the audit that have been agreed upon with the client?

A. In the certificate that we give, you mean?

Q. Yes.

A. If there had been a particular limitation that has been recognized as significant, yes, it should be set forth in the certificate, or if at the same time there hasn't been necessarily a specific elimination, but the work that you are doing does not contemplate certain things, a similar reservation should also be made.

Q. I am having in mind the annual report to stockholders of companies, some of whose stock at least is publicly held.

A. I think the accountant's report should explain as carefully as possible the facts surrounding the work that he has done without being too lengthy or too detailed, that he shouldn't leave any ambiguity as to the meaning of what he was stating.

Q. Would you say a certificate, if there were material limitations on the scope of the audit, you were to make or do you—

A. Again that would depend, it seems to me, upon the purpose of the examination.

Q. I have in mind again this annual report to stockholders of a company, some of whose stock is publicly held.

A. In the past year? What the future might bring forth I am not so sure, but as an accountant I would feel that as long as a full presentation has been made, even though the work were limited in some respects beyond normal bounds, that the statement of that limitation puts the reader on notice and should be sufficient.

Q. Looking again to this certificate on page 41, would you point out 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 "accepted principles of accounting consistently maintained."

Q. Does that signify to you consistent with the preceding year?

A. Consistent within the year and consistent with the practice of the preceding year, so that any material variation of recording or preparation would be given effect.

Q. Do you utilize that wording in your own certificate?

A. Yes, we do, where we use the certificate.

Q. Would you think it might be clarified to indicate directly that they were consistent with the preceding year, or do you feel that this is satisfactory?

A. Among accountants, it has been accepted as meaning that. I think that to me it means, and with the majority of those to whom I have talked it means, consistent with the preceding year. If there is any question in the minds of those reading our reports concerning that, probably the change would very well be in order.

Q. Now, looking at the introduction to that accountant's report at the bottom of page 40, it is indicated that matter be included in the accountant's report or in the statements for the purpose of being merely informative, to state limitations on the scope of the audit, or to indicate dissent from particular practices of the company. How would a reader distinguish as a particular matter between those various purposes in your own practice?

A. It seems to me that what is in the certificate is primarily informative and where it is felt necessary to make comments concerning particular changes of the statement as inventories or accounts receivable, that that is in limitation rather than as information concerning the work that was done. In other words, that would be interpreted in my mind as a reservation.

Q. Let us take a specific example. Take a qualification as follows:

Inventories have been certified as to quantity, quality, and condition by responsible officials of the company.

Now, if that were included on the balance sheet or a footnote thereto, would that be merely informative, would it be a qualification, or would it indicate a limitation on the scope of your audit?

A. To me it would be a qualification, but in our own practice we would couple with that a positive statement of the limitation of the work that we did do.

In other words, that we had tested pricing, and mathematical computations and extensions and done something else, but we hadn't done anything about quantity and quality but had depended upon a certificate from management.

Q. Would that be a qualification on your opinion of the financial condition of the business?

A. That would be a basis upon which the opinion we give is predicated and in the wording where we state that based upon our examination we are of such and such an opinion, that would be a limitation or reservation with respect to that part of the work.

Q. Now, if that or similar language were included in the certificate would there be any different inference to be drawn, that is, suppose it is in the second paragraph under the opinion paragraph?

A. I don't think so. I think the fact that it is presented is of major importance and not whether it is one paragraph or another.

Q. I take it then it wouldn't make any difference if it were in the first paragraph as part of the scope of the audit?

A. That is correct, to my mind.

VII. GENERAL SUGGESTIONS AND COMMENT

Q. The suggestion has been made, Mr. Mathieson, that corporations should rotate firms of auditors at frequent intervals. Do you have any opinion as to the desirability of this practice?

A. There are advantages, I think, more theoretical than actual in doing it in the fact that possibly new brooms sweep clean and a new interest is expected by making the change. Disadvantages, however, I believe offset to a large degree, if not entirely, the advantages in the fact that an auditor or accountant today is largely a consultant and that the management not only at the audit period but throughout the year more and more consults with us as to problems they have and how things are to be handled at that time.

If you are changing auditors too often, possibly some of the value of the accountant to the client is lost. We attempt to cover that, as I stated previously, by rotating men within our own organization so as to get their different viewpoints.

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

A. No; it is not.

Q. Do you think that might be desirable?

A. I think it would be very desirable.

Q. Would you expect the auditor to have the right to speak as well as to be asked questions?

A. I think the auditor in the very nature of the work he has done had better answer questions rather than advance managerial suggestions.

Q. In this long form of report to which you refer, would you feel that it is your duty as an auditor to make suggestions therein?

A. We feel it is our duty as an auditor to make those suggestions but generally speaking we would make them in a supplemental report but not in a report which is going for formal presentation to a board. Suggestions, unless they are major matters of policy, would be made to the management rather than formally to the board and stockholders.

Q. How do you get these reports to the management? Do you just send them to the management or do you send copies directly to the directors?

A. No; we don't send copies to the directors. We send them ordinarily to the president or secretary of the company. Sometimes we know they are being distributed. Sometimes we don't.

Q. Do you think that that would be a desirable thing to have them sent directly?

A. I think it would be desirable. I think if the accountant were to send his report directly to the directors and if the directors would encourage a policy of discussion of the company's affairs in proper places with the accountant, much could be gained.

Q. Now, turning to the question of natural business year, Mr. Mathieson, do you feel that the adoption of the natural business year would be a desirable thing?

A. A very desirable thing. It would take off peaks of the accountant's work, aside from benefiting taxing authorities and credit agencies and Robert Morris Associates and others, in that way enabling better attention to the problems of the client, making available more time to give to his particular questions instead of everything coming at one time.

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

A. Yes; I think that would be probably true. The detailed audit has passed with the intricacies of business and problems that have arisen in business. Today the development has been such that control of procedures and a checking of the means of seeing that those controls are effected is more the thing done than a detailed audit of individual transactions.

Q. You referred a moment ago to the accountant serving as consultant. Could you illustrate a little more fully what you had in mind there?

A. Well, the development of new product lines with respect to what the costs might be of such a product, the matter of cost control, that is cost systems to enable the business to determine or know more clearly what its costs are, matters of material control, the question of the effect of federal and state taxation on the policies which the company is pursuing, the matter of financing or refinancing, almost all of the incidents of management which come up during the year are being discussed more and more with the accountant as a consultant.

Also, as I testified earlier, part of our business is coming from banks acting as trustees where they have acquired in estates a going business. They are faced with the determination of whether to continue it, whether to sell it, whether to liquidate it, or other policies; they are faced with a determination of the opinion of the personnel very frequently, particularly where the man has died, whose estate they have, which man has been a dominating factor in that business. more and more accountants have been drawn in to give opinions as to personnel and to markets and the advisability of carrying or liquidating or selling or what might be the particular case.

Q. Will you indicate briefly the items in the balance sheet and income statement which your auditing procedure verifies to your satisfaction by tests which are independent of the accounting records of the company and information furnished you by officers and employees? Would you just run through those?

A. Cash on deposit in bank to the credit of the company would be verified by confirmation from the bank, investments that the company might have would be either inspected or in the hands of custodians confirmed as to their correctness, notes receivable, while being verified in part from the records of the business itself, are also examined insofar as seeing that formalities usually required have been complied with in making the notes, to see that they are not past due or if they are, they are being given recognition, to see that they are not outlawed by statutes of limitation which vary in different states, verification of notes payable by confirmation, verification of mortgages, possibly sinking-fund deposits with trustees, verification of capital stock either by the examination of the stubs or by confirmation from a registrar or transfer agent.

There may be others. Those are the ones I think of offhand.

Q. How about the profit and loss statement?

A. The profit and loss statement I cannot think of any item that can be verified independently of the records.

Q. I think you have said nothing as to accounts receivable and inventory. Did you have in mind there that they were verified only through the records? Couldn't you verify the inventory if the records weren't there?

A. As to quantities, assuming the inventory was of the type we could be expected to be familiar with, as to pricing, where we could obtain prices from recognized sources, accounts receivable where we could confirm with customers; yes.

Q. Now, in the second paragraph of this form certificate, the statement appears that in the auditor's opinion based upon his examination the statements fairly present the position of the company and the results of its operations. When you use this form of certificate, do you intend to mean that in your opinion as a public accountant, the examination has been sufficient to verify the existence of the assets and liabilities and the authenticity of the transactions?

A. Yes; except such reservations as may be stated in the certificate.

Q. Do you also say that you have made an examination that, in your opinion as an expert, is sufficient to enable you to make such a statement of opinion?

A. Yes; if we haven't, we shouldn't give the opinion.

Q. Have you anything further you would like to add, Mr. Mathieson?

A. I don't think of anything now that you haven't covered?

Mr. WERTZ. That is all.

(Witness excused.)

The EXAMINER. We will adjourn until 10 o'clock tomorrow morning.

(Whereupon the hearing was adjourned until 10 o'clock a. m., March 2, 1939.)