

Q. On this part, I think there is one thing I am not clear on. What is your practice as to confirming receivables—accounts receivable? Is it customary for you to make some sort of test confirmation on that?

A. We do in a great many cases. The exact percentage, I can't say.

Q. You say a great many cases. Would that be a majority or less?

A. I can't answer that.

D. INVENTORIES

Q. I would like to turn now to the question of inventories.

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

A. In my opinion, it is the responsibility of an accountant to satisfy himself that the pricing of inventories is in accordance with generally accepted accounting principles.

Q. The basis of pricing inventories involves the question of market price. What market price is meant, for example, in the usual phrase "cost or market," whichever is lower?

A. Market ordinarily means the lower of replacement cost or selling price less allowance for selling.

Q. Are those alternatives or both applicable in any given case? That is, do you use one or the other?

A. We use the lower of the two.

Q. The lower of the two markets in an individual case?

A. Yes.

Q. How do you determine what market price is applicable? Take the replacement market.

A. Well, in the case of a manufactured product, it is the current cost of producing it. In the case of a purchased article it is the current cost of buying it.

Q. In the client's market—buying market?

A. Yes.

Q. Do you have to determine whether the quantities are consistent with the client's requirements?

A. Yes; we do.

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

A. We inquire as to the procedure followed in the inventory with respect to goods held on consignment. We check the records of consigned goods with the inventory to ascertain whether or not such goods have been excluded.

Goods shipped on consignment are checked against the consignment records and we normally correspond with the consignee or consignor with respect to any stocks of major size to ascertain the correctness of the records.

Q. If you found that a particular company had been engaged in the course of business with a client on consignment, would you send out a confirmation even though the record showed no balance at the present time?

A. Yes; I think we would.

Q. Is it customary for you to make any tests to determine whether the company, in fact, owns inventories which you know to be on hand?

A. Well, the basic test of ownership, I think, lies in determining that the goods have actually been purchased and either paid for or the liability for them recognized in the accounts.

We make tests to ascertain that invoices are properly recorded, to satisfy ourselves that they cover all of the goods included in the inventory.

In a case of goods held for customers, for example, the client's records of such goods are examined and checks of the inventory are made to see that they are excluded.

Q. What is the customary procedure you follow to determine that there have not been included in sales goods which were shipped during a subsequent period? How do you go about determining that?

A. Well, we customarily review sales by months for the year and by days for the last month of the year and the first part of the following period to detect any evidence of bulges or irregularities; test of the sales cut-off is generally made at the end of the year by a test comparison of duplicate sales invoices with copies of bills of lading or whatever available shipping records there might be.

Q. Is there any difference in your practice when the goods are shipped from a point not under the control of the company?

A. Yes. If the items in that case are relatively important, the customary procedure would be to correspond with the warehouse.

Q. And that would require a detailed break-down of shipments from the warehouse so you could make the same sort of test that you made on the company's records?

A. Yes.

Q. How about purchases? How would you go about determining that purchases are properly allocated to the periods?

A. By examining the invoices recorded in a subsequent period, month of January, February, if it is a December 31st audit. By examination of receiving records, noting particularly the date of receipt and by discussing the procedure particularly with the employees who actually handled the merchandise.

Q. When you refer to receiving records, what do you mean by that?

A. Well, that means the records in the receiving department relating to the receipt of goods.

Q. You are looking again for the dates and important items?

A. Yes.

Q. Turning again to inventories, in verifying footings and extensions of the company's calculation, is it customary, or feasible or desirable, do you believe, to employ comptometer operators?

A. It very frequently is customary and feasible. In such cases we employ the comptometer operators directly.

Q. Do you feel there are any difficulties or disadvantages in that procedure?

A. No. If we have any questions we apply certain tests to satisfy ourselves that the operator is competent.

For example, we frequently will see that the work she has to do includes some errors and check to see if they are found.

Q. If the procedure outlined in the bulletin as to inventories has been completed to your satisfaction, is it customary for you to include in your report or in the statements any qualification as to your responsibility for the quantity, the quality, or condition of inventories?

A. We do not include a qualification as to our responsibility for the quality, or condition of the inventories. Normally, the balance sheet contains an explanation to the effect that quantities and condition have been determined by the company.

Q. If that statement is included, do you feel that that relieves you of the necessity of making any tests or inquiries such as are indicated by the last sentence of item 3?

A. It does not.

Q. What tests do you feel are implied by that sentence which reads as follows:

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

A. It is hard to give anything but a general reply to that question because so much depends upon the individual circumstances.

These tests and inquiries include a thorough investigation of the methods employed in determining inventory quantities. They include a review of the instructions which have been released to the company employees. The results are compared with perpetual inventories or other record controls that the company maintains; material differences are investigated and inspection of a portion of the inventories is usually made and in many cases test check of quantities by count are made.

There are numerous other broad tests that we may be able to make in particular circumstances.

We pay particular attention to treatment of prior season, or other old merchandise and ascertain, where practicable, the rate of movement or use of such merchandise or material.

In that way we try to satisfy ourselves that recognition has been given in a proper way to age and condition in pricing them.

Q. I believe you indicated that you would give careful attention to the methods followed by the company in taking its inventory.

Could you indicate any of the things which to you represent a satisfactory method of taking inventory?

A. A satisfactory inventory would require, among other things, a careful initial planning for the work, which includes an orderly placing of the stock and supervision of the work by responsible employees. Careful count, initially, usually a recount of physical quantity, correct description of units, correct description of the stage of completion of the work, notations as to defective, old, or obsolete stock and proper control of the records on which the counts are entered.

Q. When you say "recount," do you mean that that is independent of the first count?

A. Yes.

Q. Would the person have the figures for the first count before him in such case?

A. Sometimes they do. I think more often not.

Q. More often—

A. More often not.

Q. Do you think that is an essential part of the process?

A. Well, you mean—

Q. That they not have access.

A. I think it is preferable. It may not be essential.

Q. How do you establish that the client has actually followed the methods which it is supposed to follow in taking inventories?

A. Well, reasonable evidence of the observation of these points by the client can be secured by a discussion of the matter with a number of employees, the more the better the results are, usually, and by a careful review of the resulting inventory records.

Q. What employees do you have in mind there?

A. Well, we stress the importance of getting out into the stock-room, for example, and talking to operating men who do not have anything to do with the accounts.

We frequently get interesting information from a source of that type.

Q. If you feel that the methods are unsatisfactory, or have not been satisfactorily followed out, what do you do?

A. In some cases we might ask that recounts be made on particular types or units to satisfy ourselves whether or not they are right.

In some cases we have requested that a complete new inventory be taken as of a later date.

Q. Which would then relate back?

A. Right.

Q. In appraising the general integrity and accuracy of inventory quantity, quality, and condition, do you customarily ascertain and give any weight to the nature of the shipping records, receiving records, and the stock-keeping records? Is that a part of your program?

A. Yes; that is a part of the program.

Q. What significance do you attach to the independence of the personnel engaged in these different duties?

A. Well, it is important that these various duties be performed independently of each other.

That is one of the features of a good system of internal check.

Q. What type of records do you have in mind when you say that you rely, or ascertain and give weight to the nature of the shipping, receiving, and stock-keeping records?

A. What kind of records?

Q. What kind of records are you thinking of there?

A. Well, stock-keeping records might be a perpetual inventory, sometimes reflecting quantity only, sometimes quantity and cost.

Q. How about shipping and receiving?

A. The shipping part of the records should have a record of the goods that are shipped out, the person to whom shipped, and the date.

Q. And for the receiving department?

A. The receiving department should have the same sort of information for incoming goods.

Q. You would examine those records as well as the perpetual inventory?

A. That is right.

Q. I think you said earlier, Mr. Jones, that you felt an auditor should be reasonably familiar with the general nature of the more important products manufactured or dealt in by the company. Am I correct in that?

A. Yes; we do have a feeling it is essential.

Q. Is it your practice to make spot tests of any portion of the inventory by actual count or inspection?

A. In a great many cases, yes; we do make tests by actual count of certain items.

Q. Do you have any criteria as to whether you will or will not make a test?

A. We do not have any requirements for that.

Q. Who would decide that question?

A. The partner.

Q. Is it your practice to make any over-all tests of the reasonableness of inventory quantities, such as comparisons with warehouse capacity, average consumption, purchase, trade statistics, insurance coverage, tax payments, and the like?

A. We make a number of over-all tests and these may include purchases, production and sales statistics, reference to quantities in previous inventories; to a lesser extent trade statistics of production and consumption would be used.

I cannot say as to what extent the data as to tax payments, warehouse capacities, and that sort of thing would be used.

Q. Do you make any other tests that I have not mentioned here?

A. Why, I should say we probably use a number of them. I do not recall now; we have mentioned so many things.

Q. Are those adapted to the particular business, or whatever you feel are adapted to it?

A. Yes.

Q. How about this gross-profit test, do you employ that?

A. We do.

Q. Do you feel it should be on an over-all basis or a departmentalized basis?

A. On a departmentalized basis if possible.

Q. What do you have in mind when you use such a test?

A. Well, in addition to determining whether or not the inventory figures appear reasonable, we have in mind ascertaining any operating changes that may have taken place during the period that is covered or any significant changes that may be disclosed by analyzing the gross-profit test.

Q. Now, turning to merchandise that is not held under the company's control, what do you customarily rely upon to establish the quantity of merchandise held, say, in independent warehouses or in vendors' warehouses?

A. Ordinarily in verifying the quantity of inventories held in independent or vendors' warehouses we obtain confirmation covering the quantities directly from the warehouses.

In addition we examine warehouse receipts, of course, if they have them.

Q. Do you obtain any evidence as to the financial responsibility of the holder of the merchandise?

A. Ordinarily not.

Q. Do you feel that your procedure would be adequate to disclose misappropriations of the merchandise by the vendor?

A. No. Since we do not make an independent verification of the merchandise in the independent warehouse, there would not be any way of our knowing.

Q. Do you make any tests of quantity, quality, and condition that we have not discussed up to now?

A. Well, there might be a number of such tests—tie up with the previous year's inventory, previous experience of the company, a tie up of the inventory with various statistical data. We often pay particular attention to the rate of turn-over of inventory.

Q. Now, looking to the future, what procedure do you think auditors should use in verifying the quantity, quality, and condition of inventories? Have you any suggestions there?

A. The complete verification of the quantity, quality, and condition of inventory, in my mind, by auditors, is wholly impractical. The procedure of observing the taking of physical inventory and spot-testing quantities, I think, might be applied to a greater extent than it has been in the past but I am not prepared to say to what extent such procedure should be extended because I am not convinced that from a practical point of view any material or substantial extension of those procedures would, in the last analysis, be worth their cost to industry.

Q. How do you feel about participation and supervision of the inventory taking?

A. I think that is important.

Q. And would be a desirable thing?

A. Not so much from a point of view of supervision as to observe the steps in the procedure.

Also it is important, I think, to ascertain in advance of the inventory, just what a company plans to do in connection with taking inventory.

Q. A few moments ago we were discussing the question of market price. You indicated that there were alternative bases which were applied, whichever one was lower being used. Do you feel there is more than one method of determining costs in the phrase "cost or market whichever is lower"?

A. Yes; there are various methods of determining cost. It may be determined on an average basis, first in-first out, last in-first out.

Q. Would you feel that the application of one or the other of those methods might make considerable difference in the balance sheet figures?

A. It might.

Q. How about profit and loss statement?

A. It might make a difference in the profit and loss statement.

Q. Do you feel that it might be desirable to give some further indication of what is meant by cost in view of those ambiguities?

A. Not necessarily.

Q. Would you explain that?

A. I think there are many cases where we feel that the particular method that is used gives a satisfactory result, and in those cases we wouldn't feel it necessary to make any particular comment as to the manner of determining cost.

Q. Do you feel that giving only cost might disenable a person from comparing two companies in the same line of business?

A. I don't think I understand your question.

Q. If one of those companies followed one particular method of determining cost and the other followed some other method, that fact would not be disclosed, would it?

A. No.

Q. Do you think that would tend to prevent comparison of the two?

A. It might in some circumstances. It is a question whether you could make a comparison of that type.

E. OTHER BALANCE SHEET ITEMS

Q. I would like to turn now to some of the miscellaneous items on the balance sheet; looking first at item 4 on page 21, how do you determine that amounts capitalized as additions to plant represent real additions or improvements? Would you inspect the plant in that connection or what would you do?

A. This is determined by examination of invoices, work orders, improvement authorizations or contracts, and the examination is supplemented by a discussion of the work of the improvement with officers and employees of the company and where practical by an inspection of the work.

Q. You have in mind in the case of inspection there merely a casual inspection, or what?

A. No; it may go further than that. In the case of a rebuilding operation, for example, we may want to go into considerable detail with operating men as to just what is being done.

Q. On a tour of inspection?

A. On a tour of inspection.

Q. Looking at the bottom of page 34, how do you ascertain that plant units which have been abandoned have been removed or should be removed from the asset account?

A. There are many ways of discovering abandoned plant units. Examination of the current charges to the fixed assets frequently discloses that there have been replacements. Receipts for salvage are found. We make careful inquiries as to plant changes that have been made.

These inquiries should, I think, preferably be made of plant operating men and in many cases physical verification of major units that are near the end of their estimated lives is made on an inspection basis.

Q. Now, turning to insurance, what steps do you take in verifying the allocation of insurance charges as between periods?

A. That is largely a mathematical calculation in the ordinary audit except in the case of special types of coverage, and the examination of the total amount of the unexpired portion consists of a check or test check of the individual amounts of premiums paid on individual policies.

Q. Would you inspect the policies in that connection?

A. Yes.

Q. Would you use the information you obtain in that manner for any other purpose?

A. I doubt if we use it very much for other purposes.

Q. Now, at page 24 under item 2-C, you suggested that a test examination be made of creditors' monthly statements covering large balances. What is your practice in that connection? What do you consider an adequate test?

A. In the first place, I should arrange for the company to retain all such statements for examination. Then I would make a test of as many as under the circumstances I thought were necessary.

The extent of the test might vary widely depending on other steps that were taken in the examination such as confirmation of payables and it would also depend on the result of our examination of items recorded in a subsequent period, in general, as to our opinion as to the general accuracy of the company's treatment of liabilities.

Q. I believe you have mentioned this point earlier but I would like to bring it up again if I may. On page 8 of the bulletin, there is a statement that approval and entry of vouchers will be made by others than the disbursing officer. I believe you said that that was one of the important points in a system of internal check. Am I correct in that?

A. Yes; that is a necessary procedure in establishing a satisfactory system of internal check.

Q. Now, turning to taxes for a moment; do you expect your regular auditing staff to have a general knowledge of all types of taxes which may impinge upon a particular business both domestic and foreign?

A. Yes; in a general way, we expect our regular staff to be informed regarding the ordinary type of taxes that are involved in the business which they audit. We do not expect them to have a detailed knowledge of all kinds of taxes but we do expect the senior on a job will inform himself of any special taxes that are involved in a particular audit.

Q. Do you make a special point of inquiring as to taxes, tax liabilities, et cetera?

A. Certainly.

Q. Now, turning to contingent liabilities, what procedures do you follow determining the existence and amount of contingent liabilities, also what responsibility do you feel an auditor should assume in this connection?

A. Except for discounted notes and a few other items, contingent liabilities are seldom recorded in the accounts, so that the determination of their existence of necessity depends upon supplementary or collateral investigation.

Our men are expected to notice anything that would give an indication of contingent liability and to take whatever steps are necessary to satisfy themselves as to the existence or nonexistence of such liabilities.

Much of the information concerning contingent liabilities must come from the management, from employees and counsel of the client. Contracts, leases, and minutes are possible sources of information, but the primary responsibility must rest, in my opinion,

with the client and his counsel; the auditor has a responsibility to make reasonable inquiries and search for such liabilities.

Q. I believe you stated that you would consult counsel for the company in connection with such contingent liabilities as they might be aware of, such as litigation and the like?

A. Yes; I did.

Q. Do you make it a practice to review contracts yourself or would you consult counsel about that?

A. We do review contracts we discover in connection with the investigation. We don't, however, attempt to pass upon legal questions that may be involved in those contracts.

Q. Would it be customary for you to consult counsel in that connection?

A. Yes.

Q. Referring to minutes, what minutes had you in mind there?

A. Minutes of the directors', stockholders', executive committees.

Q. Do you examine those for any purpose other than the determination of contingent liabilities?

A. Yes; we examine those to determine many things and the various actions that are taken are checked to the record to see that they are properly reflected.

F. PROFIT AND LOSS ITEMS

Q. Now, turning to the profit-and-loss statement, item 1 on page 30 suggests that a working profit-and-loss statement be obtained or prepared in as much detail as is readily available. For this purpose, to what extent would you obtain and utilize financial analyses and statements which the company has prepared?

A. If the client has financial statements and analyses already prepared it saves time for us to examine them rather than build them up ourselves, and it is customary for us to use those statements. They are always checked to the records to see that they are accurately prepared.

Q. Do you make inquiry as to what statements the company usually prepares and whether they are available?

A. Yes.

Q. What is the purpose of obtaining budgets, previous annual statements, and monthly statements as outlined in item 2 on page 30?

A. The budget and monthly statements are helpful as a guide to finding items which are out of the ordinary; getting a comparison of the final figures with them may reveal differences which require further examination just as a radical departure of a particular item from the previous year's result would require inquiry or study.

Q. What do you do when you discover that there has been a difference?

A. We try to find out the reasons for the difference.

Q. How far would you go in that—until you were satisfied or what?

A. Yes; until we were satisfied that we know the reason.

Q. Item 3, under "Sales and cost of sales," outlines a procedure for analyzing allowances to customers for returned merchandise, claims, and rebates. What is the importance of such an analysis in your opinion?

A. Well, it might serve several purposes. Such an analysis might uncover a defalcation involved in fraudulent entries in allowances, discounts, or rebates.

Q. Do you always make such an examination?

A. Yes; I think we do, in most cases; yes.

Q. Now, looking generally at the profit-and-loss statement, what, in your opinion, is the responsibility of the accountant for the proper classification of income and expenses and how do you discharge your responsibility in that connection?

A. The accountant should satisfy himself that the classifications of income and expenses are substantially correct. He would make test checks and such detailed examination as would be necessary to satisfy himself that proper methods of classification have been adopted by the company.

In going about such an examination, a number of transactions would be checked out in some detail, the number depending upon the organization of the client, the method of accounting followed, and other factors.

We would also make comparison with previous years and scan the accounts for any significant items which might have some material effect on the classification.

Q. Would you consult the client's accounting instructions to the employees who would have the duty of classifying expenses in the first instance?

A. Yes; we would.

Q. And would you find out whether they understood those classifications?

A. Yes.

(Whereupon a short recess was taken.)

AFTER RECESS

Q. There are one or two questions I would like to clear up before we leave the detailed audit program. In discussing the question of confirmation of accounts receivable, Mr. Jones, you indicated that it has been customary for you to confirm in a great many cases. Could you indicate what criteria you follow in determining whether you will or will not confirm?

A. In a case of clients having a large number of accounts, for example, a public utility, we do less confirmation work than we would in other classes of work.

Q. Does that relate to the size of the sample or to whether you would confirm?

A. That relates to whether we would confirm. In any utility we might confirm the power accounts. We might not confirm any of the lighting customers' accounts, for example.

Q. Could you give us an illustration of the series of conditions under which you would confirm as opposed to those when you would not?

A. That is very hard to answer in the abstract. It depends on the particular audits, the conditions that exist; I cannot give you any general rule. It is a matter of judgment.

Q. Are there any circumstances under which you would confirm?

A. Yes; we normally do confirm receivables where there is a concentration of a substantial amount in one, two, three, or a few customers.

Q. Now, one other question: In connection with our discussion as to how you would go about determining whether a particular depository was in fact a bank or a banker, you indicated in those cases that where you did not have knowledge as to the particular depository you would make inquiries. What have you in mind there as to the nature of inquiries?

A. Among other things, we would usually find the directors' minutes authorizing signatures on banks and depositories. We have had certain cases in which we have inquired of banks that are known to us as to the character of a particular depository. Those are very seldom encountered.

Q. Would you consult a register of national banks, for example?

A. Yes; we have done that.

Q. And do you place any weight on the regularity of the papers and the transactions with the bank, such as presence of canceled checks, statements in usual bank form, et cetera?

A. Yes; definitely.

V. REVIEW OF THE ENGAGEMENT

Q. Now, turning to the question of review of the details of the audit work, in your practice who is responsible for drawing together the result of the detailed audit program and making the preliminary draft of the financial statements?

A. The senior accountant is primarily responsible for this work. It is done under the direct supervision and review of the accounting manager and of the partner.

Q. Is it customary to have the statements and working papers reviewed by any other than the person who is actually in charge of the detailed audit work?

A. My previous answer, I think, covers that. The statement and working papers are reviewed by the manager in charge of the engagement.

Q. Who would not have done any of the detailed work?

A. He may have done some detailed work also. And then, in addition, the partner in charge of the engagement reviews the financial statement and to whatever extent he thinks necessary the working papers.

Q. What is the purpose of a review of this type? What do you expect to have revealed or checked?

A. In general, the purpose of the review is to ascertain that a reasonable examination of the account in support of the financial statement has been made, that all of the work called for in the audit program has been satisfactorily completed, that all audit adjustments have been made, that there are no open points still to be settled, and that the financial statements to be certified reflect all known material facts that have a bearing on them.

Q. In order to draw the several steps together, I wonder if you would indicate or explain in some detail the individual steps which it is your practice to follow in reviewing statements and working

papers and indicate the persons who are responsible for each of those?

A. In the first instance, the working papers may be prepared by a junior or semisenior, in which case they are reviewed currently in detail by the accountant who is in charge of the engagement. Then all working papers are reviewed usually in detail by the accounting manager, and subsequent to that some of the working papers, I would not say all, are reviewed by the partner.

Q. Do you have any review department as a group which participates in this program in any way?

A. We do not.

Q. In what step in the procedure are the underlying original working papers checked or tied in to the final financial statement to see that it is all integrated?

A. That, of course, is done upon completion of the work.

Q. By whom?

A. Well, we have two checks of that type: The senior checks in the first place and then the manager in reviewing his work may recheck it and then as a final check we have a senior who has not been engaged on the particular assignment make a check of the final statement to the working papers.

Q. Would this be a fair statement of your procedure: That each person's original work is reviewed by someone else?

A. That is true.

Q. Except possibly the partner?

A. Well, the work of the partner may be reviewed by this man who references these statements back to the working papers. That is the final check.

Q. You are speaking of the senior of whom you spoke before?

A. Yes.

VI. THE REPORT OR CERTIFICATE

Q. What class of persons in your organization are authorized to sign a certificate or report?

A. All partners and any manager in charge of a branch office.

Q. Where there isn't a partner?

A. Yes.

Q. Who would draft that in the first instance?

A. Usually the senior.

Q. And then that would go through this review procedure?

A. Yes; reviewed by manager and partner.

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

A. Yes.

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

A. The function of the certificate is to state the scope of the accountant's examination and express an opinion regarding the financial statement.

Q. What impression do you mean to convey by using a certificate of this type?

A. We intend to convey, by using a certificate of this type, that we have made an audit of an adequate scope and are of the opinion that

the statements fairly present the financial position and the results of operation.

Q. Subject to any exceptions noted?

A. Certainly.

Q. Is it your understanding that the second sentence of this certificate is intended to be a reasonably comprehensive statement as to the scope of an examination in conformity with the bulletin?

A. Yes; that is my understanding of the intent of that sentence.

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

A. Well, if you mean by material some procedure that is necessary to a sound audit, I would say that probably no certificate should be issued. If the procedure were one that is generally material but not important in a particular case, no comment would be made or need be made.

Q. Is it your custom to reduce your audit engagements to the form of a written contract?

A. No; not generally.

Q. Do you prepare any sort of internal memorandum indicating the scope of the audit?

A. Yes; we do that.

Q. Would that be in greater or less detail than the description in the certificate?

A. In most instances I would say it would be in greater detail.

Q. If in the course of your discussions with the client any limitations or steps not to be performed are agreed upon, do you feel that such limitations ought to be reflected in the certificate?

A. If they are material from the standpoint of involving the integrity of the examination itself, we probably would not have a basis for rendering a certificate.

Q. And if they are not material in that respect?

A. If they are not material, they might or might not be mentioned, depending upon the particular point.

Q. Who would be the judge of materiality in both this connection and in the previous one as to omission from steps in the bulletin?

A. We should.

Q. The accountant?

A. Yes.

Q. What language in the certificate in your opinion indicates that there has been no material change either in the accounting principles followed or in the manner of their application as compared with the preceding period?

A. The words "consistently maintained," referring as they do to accepted principles of accounting, indicate that there has been no material change either in the accounting principles or in the manner of their application.

Q. Do you feel that the wording "during the year under review" possibly beclouds that meaning, or have you any feeling in that connection?

A. No; I haven't any feeling in that connection. It is possible that that particular phrase might be more explicit.

Q. Now, looking at the bottom of page 40 in the introduction to the accountant's report, it is stated that matter may be included in

the report or the statement for the purpose of being merely informative or to state limitations on the scope of the accountant's work or to indicate dissent from particular practices of the company. How, in your practice, is the reader intended to distinguish between these various purposes as to a particular matter?

A. The wording of any comment in the certificate should disclose definitely what is intended, in a manner which is intelligible to the informed reader.

Q. Do you feel that the position of the language has any bearing in this connection, comparing the position in the statement or in foot-notes on the one hand, and on the other hand, a position in the scope paragraph or in the opinion paragraph?

A. We would not put a qualification into the statement in the ordinary case; that would go into the certificate.

Q. Would you state generally that merely informative matter would not be included in the opinion paragraph?

A. Correct.

Q. But that only the qualifications you wish to make would be included there, in the opinion paragraph?

A. The opinion paragraph would contain a reference to a qualification that is presented immediately ahead of the opinion paragraph or would contain the qualification itself.

Q. And all of the qualifications you wish to make would be in one of those two places with a reference at least in the opinion paragraph?

A. In practically all cases. There may be an exception where the opinion paragraph will refer to comments on the financial statement.

Q. As a qualification?

A. As a qualification, that is, there would be a wording that will indicate that the matter referred to in the statement is a matter of qualification.

Q. I believe you stated earlier that the common language, "Inventories have been certified as to quantity, quality, and condition by responsible officials of the company," would not indicate a qualification but be merely informative.

A. Merely informative; yes.

Q. Would your opinion differ if that were included in the opinion section of the certificate?

A. That would depend on how it was presented. If it was presented as a qualification, obviously that is what it would be.

Q. The mere inclusion of that language without any reference in the certificate would make it merely informative matter?

A. I think so.

VII. GENERAL SUGGESTIONS AND COMMENT

Q. We have received a suggestion, Mr. Jones, that corporations should rotate auditors at frequent intervals. Have you any opinion as to the desirability of this practice?

A. In my opinion any arbitrary requirement that corporations rotate auditors at frequent intervals would be highly undesirable.

When a job is undertaken for the first time, considerable work is required which does not have to be repeated in following years, but

which does have to be done by each new accountant. We build up permanent files to carry along important information from year to year, such as data with respect to significant contracts, duties of officers, charter, bylaws, basis of carrying physical assets, content of the surplus accounts and a host of other matters which once obtained does not have to be dug up the second time.

The benefits of bringing new viewpoints to bear upon the job are obtained by rotating the accountants on the assignment from time to time, but all members of the staff have the benefit of the permanent files which are available on each assignment.

The rotation of auditors not only involves loss and expense, but prevents the accountant from obtaining as thorough an understanding of the client's business over a number of years as is done in the way I have just mentioned.

Q. You think that that outweighs any possibility of advantage from the new point of view that another auditor, that is from another firm, might have?

A. I do. We feel we get the change in point of view by changing men within the organization.

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

A. It is not customary, but there are many cases in which representatives do.

Q. How about stockholders' meetings?

A. Very infrequently.

Q. How do you feel about that practice?

A. I believe that it is desirable for accountants to have direct contact with the board of directors.

Q. Would you expect the auditor to have the opportunity to speak if he wished to bring up anything at one of these meetings in that connection?

A. Certainly.

Q. Is it customary for your firm to send copies of your reports to the directors in advance of the meeting?

A. It is not our policy to send copies of our reports to directors.

Q. Would it be desirable, do you think?

A. It might in certain cases. I think it is desirable for the directors to have copies of our report at the time they are passing on the report to stockholders.

Q. Do you refer there to your long-form report as compared to the stockholders' annual report?

A. No; I had in mind the short-form report.

Q. If you prepare a long one, do you think the directors should be furnished copies of that?

A. If I were an executive I would want my directors to have a copy of that.

Q. Do you know whether it is customary for directors to have a copy of the reports in advance of the meeting?

A. It is in a great many cases.

Q. Do you furnish enough copies of your reports to the management to permit that, or do you know whether the management goes ahead and duplicates it in sufficient numbers?

A. Usually the company has a printer's proof or draft of their stockholders' report which contains it.

Q. How about the long form, if you make one?

A. I cannot say as to what extent the practice of getting directors' copies of the long-form report is followed. I do not know.

Q. Do you feel that auditors should point out in the statement or in their reports significant developments or changes during the period audited?

A. In large companies that have competent comptrollers, the interpretation of the financial statements which would cover significant developments during the period under audit ordinarily is taken care of by the comptroller, who has a much more comprehensive knowledge of the business than an independent auditor can have.

In the case of small companies, we often render detailed reports in which we do point out changes or comments regarding the results of operation, changes in financial position, statements of the source and application of funds, and any other comment which we think would be of interest to the company.

Q. Do you generally make such analyses for your own files, even though you do not send them on to the company?

A. Yes; we do.

Q. If those analyses disclosed important things that you thought ought to be brought to the attention of the company, would you do that?

A. Certainly.

Q. How do you feel about the adoption of the natural business year by companies? Do you feel that that would be a desirable step?

A. Highly desirable.

Q. Could you indicate how that would assist in the audit program or the audit work?

A. Well, if more companies were to adopt a natural business year, there would be a considerable reduction in the peak concentration of the work in the first part of the year. It would substantially reduce the tremendous pressure that almost every accounting firm is under at that period.

Q. Have you made any analysis of your clients to determine the extent to which such distribution of work would be obtained?

A. No; we have not made an analysis to determine how much. We have analyzed all of our clients to determine which ones should, but we have not attempted to determine what proportion, for example, of the clients that represents.

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

A. The determination that accepted accounting principles and conventions have been followed is an important phase of the audit, but it cannot properly be said that auditing procedure is mostly concerned with that.

Q. Now, looking at the several items in the balance sheet and profit and loss statement, which of those would you say your auditing procedure verifies to your own satisfaction by tests which are inde-

pendent of the accounting records of the company and information furnished by employees and officers?

A. That is a hard question to answer. There are, I think, relatively few items which can be verified to our satisfaction in that way. We, of course, get confirmations on cash, notes receivable, accounts receivable, and securities in many instances, but usually those confirmations have to be related to the accounting records.

For example, a confirmation of a bank balance does not mean anything unless you can relate it to the bank balance on the books.

Q. Does it tend to confirm independently of the records?

A. Yes; when reconciled with the record. On the liability side of the balance sheet it is possible to satisfy ourselves as to the actual existence of most of the liabilities by confirmation; but without an examination of the books it would be difficult to satisfy ourselves that all liabilities were included.

Capital stock can be checked independently if the client has a registrar and transfer agent.

In the case of profit and loss, there are relatively few items which can be independently verified, rents, royalties, sometimes insurance, taxes maybe. Most of the other items are difficult to verify independently, on the whole; some of them might be partially verified.

Q. To what extent do you feel an auditor is entitled to rely on information obtained from the management as to facts or conditions which might be determined by independent observation?

A. I think the auditor should make the independent observations in those cases.

Q. Having in mind the relative expense and difficulty?

A. Yes; it has to be reasonable and practicable.

Q. The second paragraph of the form of certificate outlined in the bulletin states that in the auditor's opinion based on his examination, the statements fairly present the position of the company and the results of its operations. When you use this form of certificate, Mr. Jones, do you mean that in your opinion as a public accountant the examination made has been sufficient to verify the existence of the assets and liabilities and the authenticity of the transactions?

A. To comply literally with the expression, to verify the existence of the assets and liabilities and the authenticity of the operations, would mean, I think, that the accountant would have to include in his examination a physical inspection of such things as plant and property. He might have to ascertain the matter of title and, in addition, it would probably require a detailed examination of each transaction.

The language used, I think, is not descriptive of the accountant's work. As the bulletin indicates, the accountant approaches the audit of financial statements through the medium of its accounts. We mean to imply in our certificate that we have made such tests and examinations of the client's accounts and records and supplementary documents, and have made such inquiry that we have reason to believe and no reason for disbelief that the statements which we are certifying fairly reflect the condition of the company and the results of its operations.

Q. When you make such a certificate, do you also mean that you have made an examination which you as an expert feel is sufficient to enable you to express an informed opinion of this character?

A. Certainly, we do.

Q. Have you anything else you would like to add?

A. The only comment I would like to add relates to the matter of the possibility of codification of principles of auditing, and of establishing detailed rules to govern auditing procedures.

In my opinion the procedures to be followed in conducting an audit cannot be reduced to rule any more than the procedures to be followed by the doctor in examining a patient can be.

Broad outlines of auditing practices may be laid down. Certain generalities can be expressed in some detail such as has been done in the pamphlet Examination of Financial Statements and in auditing textbooks, but the heart of professional skill, in my opinion, consists of judgment, intelligence, alertness, and instinct developed by long periods of training and experience under widely varied situations which do not submit themselves to codification.

When an auditor undertakes a new assignment, he can lay down certain principles governing his approach to the problem; but his ultimate procedures will be determined by the types of accounts kept, number of employees, system of internal check, the attitude and action of the management, incentives for misrepresentation, and a host of other items so subtle in their influence that they cannot be analyzed.

The principles of accounting can, and I think should be established, but the procedures involved in auditing do not permit of any successful attempt to reduce them to rules sufficiently detailed to be of any practical guide other than as to the most general description of the method of approach. So much depends upon the ability of the auditor to draw conclusions of significance from apparently unrelated facts, to be alert to detect insincerities, inappropriate actions, unbalanced procedures, et cetera, which should draw attention to special conditions, or suggest investigations along particular lines, that it is impossible to chart any detailed course of action for him to follow.

In auditing there is no substitute for judgment and intelligence; and the application of any detailed code of auditing procedures will, in my opinion, inevitably defeat the purpose for which they are intended.

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

The EXAMINER. Mr. Henderson, have you any questions?

Mr. HENDERSON. No.

The EXAMINER. Thank you, Mr. Jones.

(Witness excused.)

Mr. WERTZ. Mr. Examiner, before adjourning for the day I would like to put a brief statement in the record as to this part of the hearing. The appearance of Mr. Jones concludes, for the time being at least, our examination of members of various accounting firms. In having these witnesses appear we have sought to obtain a representative cross section of the auditing practices and procedures in general

use today. Other public accountants, and many persons not accountants, have written us their suggestions as to possible improvements in auditing procedure or in the relationship of the auditor to corporations, the securities of which are publicly held. At this time we should like to urge that anyone else having constructive suggestions as to these related questions also communicate them to us.

I would like to adjourn until Friday at 2 p. m.

The EXAMINER. Very well; we will adjourn until Friday at 2 p. m.

(Whereupon the hearing was adjourned until 2 o'clock p. m., March 17, 1939.)