

PROCEEDINGS

FIFTY-THIRD ANNUAL MEETING

of the

AMERICAN INSTITUTE OF ACCOUNTANTS

EXPERIENCES WITH EXTENSIONS
OF AUDITING PROCEDURE

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Hotel Peabody
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EXPERIENCES WITH EXTENSIONS OF AUDITING PROCEDURE

Thursday Morning, October 17, 1940

The meeting on Experiences with Extensions of Auditing Procedure, held in connection with the Fifty-Third Annual Meeting of the American Institute of Accountants in the Hotel Peabody, Memphis, Tennessee, October 15-18, 1940, convened at nine-thirty o'clock, Mr. Samuel J. Broad, Vice President of the American Institute of Accountants, and chairman of the Committee on Auditing Procedure, presiding.

CHAIRMAN BROAD: Will the meeting please come to order?

Gentlemen, our session this morning is devoted to the subject, "Experiences with Extensions of Auditing Procedure."

... Chairman Broad read his introductory remarks (Marked No. 1). . .

CHAIRMAN BROAD: In dealing with the subject of the program this morning, we have three papers which relate to matters of procedure, procedure regarding inventories and regarding accounts receivable, and regarding internal check and control, and another paper which deals with the more general subject of accountants' reports, opinions--certificate, call it what you will.

We had another paper scheduled with regard to this subject from the standpoint of the smaller practitioner. Mr. Mayo was scheduled to give us that talk, and I know you will be very sorry with me that he is not able to be here. I have a wire from him that, owing to the death of his brother, he wasn't able to get away, so we won't be able to deal with that subject this morning.

The first paper on the program is with regard to extensions on inventory procedure. Mr. Prior Sinclair, a member of the Institute, and a man active in the Institute for many years, a member of many of its committees, will now speak to us on the subject of "Inventories." Mr. Sinclair!

... Mr. Prior Sinclair read his prepared paper (Marked No. 2) . . . (Applause)

CHAIRMAN BROAD: I am sure you have all enjoyed this quite thoughtful paper by Mr. Sinclair. One thing struck me, as he was dealing with these various examples, that in practically no two cases were the problems similar, and in practically no two cases was the evidence by which the auditor satisfied himself of exactly the same nature. It is just a case where the auditor has to use the inventory at his disposal. I think Mr. Sinclair pointed, either directly or by innuendo, that reliance was primarily on methods, and testing in quantities was incidental thereto in most cases.

The next speaker on our program will deal with the subject of "Internal Check and Control." Mr. Charles H. Towns has been active in Institute affairs for many years. I think he is undoubtedly known to most of you, and I am sure, with his experience on committee work with the Institute, chairman, and member of many important committees, he will bring you a message which will be quite interesting and quite helpful. Mr. Towns.

MR. CHARLES H. TOWNS: First, let's try to get a common understanding of what we mean by "internal check and control." In that connection, there is an old story that I would like to tell of the man who was standing near a telephone operator's desk when the colored boy came in and went into one of the telephone booths. He called a number in a residential district. He left the door open, and the man standing there could hear one end of the conversation.

The boy said, "Is this Mr. Johnson? Well, Mr. Johnson, I read in the paper this morning that you want to hire a boy. Oh, you already have a boy for that job. Are you sure he is going to be satisfactory? You are really sure he is going to be satisfactory?"

When the boy hung up and came out, the man standing there wanted to hire a boy, so he said to the young chap, "It is too bad you couldn't get that job you were trying to get."

"Oh," the boy said, "I don't want that job. I have already got that job. I was just calling up to check up on myself." (Laughter)

He was practicing a form of internal check and control. He was checking up on himself without any professional assistance. (Laughter)

... Mr. Charles H. Towns read his prepared paper, "Internal Check and Control" (Marked No. 3) ... (Applause)

CHAIRMAN BROAD: I am sure you have listened with a great deal of interest and benefit to this very thorough treatment of the subject by Mr. Towns. I have been rather sorry a number of times that in the pamphlet put out last year, "Extensions of Auditing Procedure," we had only three main subjects, "Interest," "Receivables," and another, which was "The Formal Report, or Opinion." I am sorry we didn't have any caption for "Internal check and control," because to my mind that is one of the most important matters dealt with in the pamphlet.

If you look back to the bulletin, "Examination of Financial Statements," issued in 1936, you will see that nothing is said there about the effectiveness of the internal check and control. The auditor was given responsibility for passing upon the adequacy of the system, but the word "effectiveness" was not used. In the bulletin, "Extensions," the responsibility was placed upon the auditor to pass upon the effectiveness of the system. I think in the past year we have been

giving more and more attention to the subject, and I think as forward looking accountants we have to continue in this direction.

The next subject heading of our meeting today is the extent of procedures with regard to accounts receivable. That subject will be dealt with by a member of the Committee on Auditing Procedure of the Institute. As most, if not all, of you know, one of the present tasks before the committee is revision of the Institute's bulletin, "Examination of Financial Statements." Mr. John A. Lindquist, who will now address you, has been particularly dealing with the subject of accounts receivable, and I am sure you will listen with a great deal of benefit to what he has to say. Mr. Lindquist! (Applause)

... Mr. John A. Lindquist read his prepared paper, "Accounts Receivable" (Marked No. 4) ... (Applause)

CHAIRMAN BROAD: Thank you, Mr. Lindquist.

I think there is room for a lot of thought in some of the comments Mr. Lindquist has made, and I was particularly interested in his comments or his suggestion, with which I think we all of us will agree, that it is our right to determine the procedures on which we shall base our opinion, and the right of the profession and of the individual auditor in a particular circumstance.

I have an announcement to make.

... Chairman Broad made an announcement ...

CHAIRMAN BROAD: That ends the part of our discussion which relates to auditing procedure, and I think it follows naturally that we should go on from there to deal with the nature of the report which follows the work we do in making an examination.

The subject of the next speaker will be “Auditors’ Reports,” by Mr. Rodney F. Starkey, who has been chairman or a member of a number of committees, and I am sure he is as well equipped as anybody to deal with this subject. Mr. Starkey! (Applause)

... Mr. Rodney F. Starkey read his prepared paper, “Auditors’ Reports” (Marked No. 5)
... (Applause)

CHAIRMAN BROAD: From Mr. Starkey’s remarks, I think it will be clear to you that we are not through with the form of auditors’ reports yet, and we probably never will be as long as we stay in business. Accounting, auditing, reporting, have all been in a constant state of development. We will be comfortable, this is the final thing, this satisfies everybody, it satisfies us, but from now on there will be no change--I don’t think a progressive organization will ever reach that stage.

That ends the part of our program devoted more or less to formal papers. We thought it desirable to hold discussion over until the latter part of the meeting. There are no doubt a number of you who may have some comments, or who would like to ask some questions. I can’t assure the questions can be answered, unless somebody on the floor will do it. We will do our best to get an answer for you.

MR. EDWARD B. WILCOX (Chicago, Ill.): Mr. Chairman, I would like to ask Mr. Lindquist if he could elaborate for me, or tell me anything about what to do when large customers, who may be few in number, refuse to respond. I have in mind definitely, Sears, Roebuck, Montgomery Ward, and Macy’s. If you write to them, and they write back and say, “Our records are in such shape that we don’t know what the total of this customer’s account is,” what do we do, just fold up?

CHAIRMAN BROAD: I thought Macy's did an entirely cash business. I will ask Mr. Lindquist to answer that.

MR. JOHN A. LINDQUIST: I must admit that so far as organizations like the large chain stores are concerned, that refuse to reply to a request for confirmation, I haven't got the answer. Maybe someone on the floor has.

CHAIRMAN BROAD: I think there have been cases where some firms--I don't know to what extent this is being followed--have looked over the accounts receivable, particularly toward the end of the year, with the idea of seeing whether there had been any padding of sales in the later months. Where a confirmation is not received, we probably need some other kind of evidence, particularly with reference to a large account. I know there have been cases where I have deemed it desirable to look up some of the shipping records, or something, toward the end of the period, either in loss of a particularly large account, or particularly with reference to sales generally, if they seem to be large in a particular month.

MR. EDWARD B. WILCOX (Chicago, Ill.): Mr. Chairman, may I add a word on that note? The thing I wanted to establish right, is that it seems to me we are forced really back, where we run into a dead wall like that, on other means of verification, even though we hold out that we prefer the means of the direct communication.

CHAIRMAN BROAD: Thanks for answering your own question, Mr. Wilcox.
(Laughter)

Has anybody else a comment?

MR. A. LEE RAWLINGS (Norfolk, Va.): I would like to ask a question about the receivables that was not touched on by the gentleman who read the paper, and that is receivables of municipalities and counties, which is getting to be quite a part of accountants' work. I would

like to know what experience this gentleman has had with them, or anyone else here, the verification of them.

CHAIRMAN BROAD: Is that a question you would like to answer yourself, Mr. Rawlings? We would be very glad if you would.

MR. RAWLINGS: I will give my opinion, but I would like to have somebody else's opinion. To what extent do you do it? Do you consider it necessary?

CHAIRMAN BROAD: Does anybody want to throw any light on that subject, to what extent is it desirable to confirm the accounts receivable of a municipality?

MEMBER: What are the receivables?

MR. RAWLINGS: Taxes principally, special assessments, and what-not.

CHAIRMAN BROAD: We are looking for some help here. If anybody can give us some, it will be very welcome. Personally, I have not had very much experience with municipalities. I haven't run into the program.

MR. WILLIAM H. WELCKER (Philadelphia, Pa.): The requirements in New Jersey are now such that every auditor must confirm the taxes to the extent of ten per cent. It seems to me that is a very excellent thing to do. We have discovered several shortages by doing that--ten per cent of all the outstanding taxes, water rents, and such other items in accounts receivable.

CHAIRMAN BROAD: The State of New Jersey thinks it is practicable and needful to do it?

MR. WELCKER: Yes, sir. It is required in every municipality.

MR. GEORGE D. BAILEY (Detroit, Mich.): The meeting of the Municipal and Finance Officers Association, in Detroit this spring, discussed that matter a little bit, as to whether the results from such confirmation were sufficient to justify the time and expenditure. There was a

feeling that confirmation on personal property taxes could be expected to be reasonably responsive, but the confirmation of real property taxes proved to be completely unsatisfactory.

The other side of that is that the real property taxes are in most states subject to sale, so that there is an eventual peg against the validity of past due real property taxes. There isn't that same peg as to the validity of the personal property taxes.

My own experience has been that confirmation of personal property taxes by test or after the date the taxes are supposed to be paid--it is sometimes possible to make a complete communication as to personal property taxes which proves satisfactory. As to real property taxes, it hasn't worked out, in my opinion, to give a sufficiently responsive answer.

MR. EDWARD B. WILCOX (Chicago, Ill.): Mr. Chairman, is there a rule against too many appearances by the same member?

CHAIRMAN BROAD: No.

MR. WILCOX: This interests me unexpectedly, because I hadn't expected any such question.

Taxes receivable--I am speaking now from the standpoint of Illinois, but I don't know that Florida is very much different--are assets of municipal bodies, such as villages, cities, counties, school districts, park districts, and other miscellaneous districts. At least in Illinois, taxes receivable are collected by the county and distributed to the municipalities. The county is merely the channel through which they flow. The county has neither an asset nor a liability, except as it has undistributed taxes on hand which are comparatively small in amount, unless it is withholding them improperly. The municipality has its taxes receivable which are based on its levy. From time to time it has received part of its taxes and has the rest of them as uncollected, and that fact can be verified from the records of the county.

What I am getting at is that I think in the set-up of the municipal organizations we have a good system of internal control on which we can rely, because the county is independent of the village. The village makes its assessment. The county clerk--at least in Illinois--extends the amounts, determines the tax. The county collector collects it and remits it back to the village. If you go from the village to the independent records of the county, I think you have gone far enough. I would be rather astonished to think that you should go from the county records to the taxpayers who owe a tax bill that covers possibly fifteen or twenty municipalities in order to determine how much that taxpayer owes.

There are other aspects of the question. Of course, special assessments which are owed directly to a municipality, or fines or forfeitures, are in another status, but the general real estate taxes are items that are assessed and can be followed through the independent records of the county. I wouldn't expect it would be feasible to go back to taxpayers for direct confirmation of such things as that.

MR. EDWIN H. WAGNER (St. Louis, Mo.): In my opinion, it is unreasonable and impracticable to send out these confirmation statements in the case of the larger department stores. First off, if we are not going to become collectors, we must necessarily send two envelopes with each of these statements, whether they be positive or negative confirmations.

If they be negative confirmations and we send the two envelopes, we have had the reaction from our clients, some of them, that it will be injurious to their business, because such a large proportion of their charge customers are of the feminine variety. I am not casting any reflection on the women but, as you know, they are not so conversant with these affairs. So I do think we should not be insistent in exacting of these corporations that we do send out negative confirmation statements. We do have other means of verifying or substantiating these accounts,

by reason of taking the total charges and the total collections per month and adding the aging of the accounts receivable, which should be done with meticulous care.

That is all I have to say about the department stores.

But I would like to get back to Mr. Sinclair's paper. I realize that he had to limit his remarks in respect of the various industries. He touched upon mines in respect of the inventories.

We take a coal mine, whether it be hard coal, soft coal or a semi-anthracite coal, and we don't know that that coal is all practically the same grade. We are not disturbed with the cost of that so much, because we have the costs through the books, but we are disturbed with the quantities, in that that isn't an easy matter to determine. So it is with fire clay; so it is with stone, with marble, and maybe with copper, copper mines such as we find in Nevada, in Arizona, or in Utah, where they strip the earth down to the ore body until they come to the copper deposit, which is of a low grade, running from one to two per cent. That copper, being uniformly of that grade or percentage of metal in the ore, we haven't any difficulty in determining the values, but we do of quantities. Therefore, I think we must rely upon the certificate of the mining superintendent or engineer as to the quantity of ore in certain piles.

I will take you then to the lead districts of Missouri, in the decimated district where we have the lead impregnated in the limestone and which, over a period of seventy-five years, has been of a uniform assay, running four per cent. We do know that that lead ore as it comes to the top from the mine has four per cent. We are not concerned with the ore at the moment, because that ore immediately goes into the crushers, through the rolls, through the jigs, through the tables, and so forth, and until the flotation process was discovered it went into slimes and the

slimes went down the creek beds. Now, with the flotation process, they are recovering probably fifty per cent of the metallic lead out of the slimes.

Recently, in the case of fluor spar, the same thing has happened. Therefore, I think we should not get our necks out too far in respect of educating the public to the fact that we do stand back of these inventories. I realize there are many, many businesses where we can substantiate the inventories, but there are so many others that we cannot, that I hope in the supplemental or revised pamphlet on auditing procedure and report on financial statements that we don't go too far on inventories. (Applause)

CHAIRMAN BROAD: I think, in recognition of the difficulties Mr. Wagner has mentioned, the view of the committee is that we should stress methods of taking inventories, rather than what is it. Mr. Wagner spoke of the difficulty of knowing what is it. I think two or three of the speakers have stressed the importance of methods, who takes the inventory, how is it taken, how many people have part in it, are the people likely to have a financial interest in the business, and so forth.

MR. SEIDMAN (New York, N.Y.): I would appreciate getting Mr. Sinclair's views on two disassociated inventory questions. One is whether, in the concept of practicability, factors within the house of the accountant as distinguished from his client are admissible. You may recall that in the Institute bulletin it was set forth that unless there be a wholesale movement toward the natural business year it would be a physical impossibility, if all companies taking inventories on December 31, or as of that date, deluged the accounting profession and called for the observation of these audit extension practices.

In light of the fact that there is still a heavy preponderance of calendar year situations, is it an impracticability within the concept of the bulletin if, as a physical matter, the accountant regularly employed by the client hasn't the available staff to observe the necessary procedures?

MR. PRIOR SINCLAIR: I believe the meaning of "impracticability" in relation to the determination of inventories doesn't countenance the fact that a man would be excused from making such appropriate tests so as to lead to an understanding of what the inventory values were, because he didn't have time or didn't have the personnel.

It is a problem to conduct all these as of December 31, but we found clients who were quite willing to consider arranging for inventories prior to that date and carrying forward the figures through the ins and outs, so as to produce the inventory total at the balance sheet date. That has spread the work to some extent, where it hasn't been their desire or they couldn't bring about a change of fiscal years. It has made us work harder, spread us a little thinner, reduced the hours of sleep, but I don't think we cannot perform the task.

I also think that when we first spoke about the tremendous burden of work, it was with the conception of accountants going in and weighing and counting everything in the plant, which would take a lot of time. With the revised later interpretations and further consideration, that viewpoint has been dissipated to a large extent. What we are doing is spending time on procedures, and we are having them observed, and see that they are inventoried and get a sense of bulk and volume. The actual physical counting is a small part of it. Two men can, in a plant day, actually count some sixty-seven per cent of the total value of the manufactured inventory. They bring their manufacturing up to completion, the units are there in their full assembled state, and there is very little behind it. You go down there and see them one after another, regular catalog stock which they sell under serial numbers, and the serial numbers account for the entire

year's production. You can tie in production reports. It is a big percentage of inventory, and is not a big job in point of time and effort. We are not going to count screws, bolts, washers, and all that sort of stuff, which a lot of people thought was the intention of the extended procedure when first announced.

MR. THOMAS A. WILLIAMS (New Orleans, La.): May I ask Mr. Seidman's guidance to ask a question on the same point.

Where you have an inventory that is kept on a card index or card index system by quantities, and which is not controlled by the general books, would it be considered good practice for the accountant during the year--let me say, first, this card system is kept very accurately by the client, who has special employees trained to do nothing else but keep this record, and that at the end of the year the record is verified by comparison with the physical inventory, and adjustments are made in this record to account for any differences after those differences are run down. Now, would it be good practice for the accountant during the year to make tests by taking physical inventories of certain items, and comparing them with this card index system, although it is not controlled by the general books, and then at the end of the year accepting the card index system as correct after comparison with the client's physical inventory, and of course observing the procedure that was followed in doing that?

CHAIRMAN BROAD: I think your question really falls down to this: What is the meaning of well kept and controlled perpetual inventory records? There has been a fair amount of discussion on that point.

I think the consensus is--and there has been some objection to this, I believe, but not very much--that control does not necessarily mean financial control on the general records; that there could be well kept and controlled perpetual inventory records without having a dollar amount, or

an amount for the general or cost ledger. In that case, such a system would meet the requirements of the extended procedure if the work was done throughout the year.

MR. SEIDMAN (New York, N.Y.): This is more limited. Some have been following the practice in recent years of calling in independent appraisers or engineers to pass upon the inventories in terms of quantities, condition and valuation, and these independent professional agencies issue a report on the inventories.

I would like to ascertain Mr. Sinclair's views on the extent to which he regards the accountant's or auditor's duties to relief, wherever that is the case, in respect to inventory.

MR. PRIOR SINCLAIR: In my experience, I haven't had to deal with any of these appraisers' inventories except under unusual circumstances, reorganizations, or bringing together of two companies, where different methods of valuation were abandoned in order to bring about some uniform method of valuation. But I would think that an appraisal by independent appraisers, while it wouldn't suffice to have us totally throw aside our responsibilities in relation to inventory, would be additional collateral evidence, particularly if it tended to substantiate the information you could develop from the company's records and from the stores records, from the book accounts, and other things, all of which pointed toward the amount which is expected constitutes the inventory in dollars and cents, and of which the quantity is one of the factors in determining that amount.

I wouldn't think we would want to rely on that alone. I wouldn't like to take an appraiser's inventory. I still think I would like to go out in the plant and see the inventory and find what they did about controlling it, how it was tied into their production records, and the other factors which management uses in the business, and not take this binder separately, inside at a desk, and say that is the inventory.

MR. ERNEST H. FLETCHER (Detroit, Mich.): We had a specific experience along this line this spring. An appraiser made a report of an inventory, raw material, work in process and finished merchandise, and we found it necessary to cut the value of that inventory down by about thirty-five per cent, and yet we received a certificate from a national firm of appraisers as to the value of the inventory.

CHAIRMAN BROAD: I can perhaps add a word on that point, if I may. The question was asked me recently. I was chairman of the Committee on Auditing Procedure. I didn't give my reply as chairman of the Committee on Auditing Procedure, but I think my personal reply will be subject to preview by the committee.

My reply was to this effect: that where the appraiser has done a considerable amount of work in taking the inventory and checking quantities in dealing with condition, description, and so forth, it would seem foolish for an auditor, who knows less about that particular phase of the subject than the appraiser, to repeat the work of the appraiser, but that he still would have his responsibility for inventorying in all other respects to tie up the books, the question of ownership, the extent to which he can get into questions of ownership, the basis of value on the lower than cost or market, or whatever basis is taken on appraisal value, and all these other matters very important to inventory, as distinct from quantities of inventory, should be passed upon by him and should still be covered by his examination; that to take a figure and put it on the balance sheet and accept it without any further review was probably not meeting the requirement. I said, further, where the auditor had relied entirely upon the appraisers for the determination of quantity, condition, and so forth, he would probably, as a matter of self-protection, say so in his report. That was just my personal opinion.

MR. JAMES F. HUGHES (New York, N.Y.): I would like to ask Mr. Fletcher if he would just add to that a word about that out of thirty-five per cent. It isn't clear to me why the accountant should take the risk of cutting the appraiser's figure by so large a percentage.

MR. ERNEST H. FLETCHER (Detroit, Mich.): The values were arrived at from the standpoint of appraisal, and not cost or market.

MR. LYLE R. SPROLES (Ft. Worth, Texas): You talk about an appraiser putting a value on something. We have a cost or market, whichever is lower, for tax purposes. Regardless of how much value an appraiser would put upon any particular inventory, and so forth, how can the accountant accept that where the appraiser is not going on cost figures at all? He is an expert. We are not experts on all kinds of inventories, whether they be department store, metals, or what-not.

So I think the accountant's responsibility is seeking how the inventory is priced, and forget all about the appraiser's valuation of it. Most appraisers don't go by costs at all; they go by present value.

MR. ALBERT J. WATSON (San Francisco, Calif.): I am very much interested in Mr. Starkey's streamlined certificate. As I gathered, if I heard correctly, the opinion remained along the same lines, the opinion paragraph was changed very little. However, no reference was made to the scope or to the basis upon which the examination was made.

Am I correct, Mr. Chairman, in assuming that your committee is considering such a change?

CHAIRMAN BROAD: We considered it and abandoned it. (Laughter) Frankly, most of the members of the committee thought they would like it, but they didn't think they could put it

into effect at this time, or even suggest putting it into effect at this time. Mr. Starkey says he talked about the ultimate goal. We haven't reached the ultimate yet.

We have time for about one more question in discussion.

MR. LOUIS H. PILIE (New Orleans, La.): I merely want to relate how one of our clients solved their inventory situation before we ever got on the scene. There were about fourteen or fifteen branches in different small towns, and every year the inventory problem was quite great. They devised a scheme of setting an incentive for accuracy on the part of their various store managers by doing this: They pay a bonus to each store manager on the percentage of increase in profits over the previous year. They also pay a bonus when the particular store manager's store has shown a better ratio of increase over all the other stores.

They take the inventories of the different stores by having the managers of other stores take them. Then the argument begins as to whether or not the cost or the pricing has been placed too high or too low, but when it is all finally set, the inventories at the various stores are rather accurate from an accounting standpoint. (Applause) I didn't want to pass the opportunity of saying that.

CHAIRMAN BROAD: If there are no further questions, we will adjourn.

... The meeting adjourned at eleven-fifty o'clock ...
