

Q. I see. Now, under what circumstances, if any, would you think that confirmation is particularly desirable in accordance with this sentence, or is necessary, perhaps?

A. When you are not entirely satisfied with the system of control or perhaps hear some suspicion of irregularities.

Q. Suppose that a large percentage in value of the accounts receivable are concentrated in a few accounts, comparatively speaking; would that be a situation in which you think confirmation would be necessary?

A. Well, I can think of a company which does business with railroads and public utilities and also general business and miscellaneous. I would not think it any more necessary to confirm the public utilities or railroad accounts which are much heavier than I would the others. I would expect to find less trouble with those accounts, I think.

Q. Do you think it would cost very much to confirm, say, where you found this condition of concentration, to confirm the larger accounts?

A. No; you could confirm, in many cases, in large proportions in total amount with a comparatively small number of items.

Q. Do you feel that a sample check of that sort would be a desirable addition to the audit program?

A. I hope that there will be more of it in the future.

Q. Now, you have indicated that under some circumstances confirmation might, in your opinion, be necessary. How would you say the cash credit and adjustment record of the individual accounts affects the desirability or necessity of confirmation, or doesn't it have anything to do with it?

A. Well, if a customer is paying up promptly and regularly, I think I'd have less suspicion of the accounts than otherwise. Does that answer your question?

Q. That answers the first half. How about the last half, the adjustment record. I mean, through a customer who is continually returning merchandise or giving allowances.

A. I recently went over a group of accounts receivable where there were a lot of adjustments, claims and, of course, it showed up in the analysis of the accounts receivable. It had more bearing on the amount of reserve for uncollectible accounts than it had on my feeling of authenticity of the accounts.

Q. I see. Suppose at the time you come into the audit that the accounts receivable at the balance sheet date have been shown as collected in the records. Would that affect your judgment as to the desirability?

A. I wouldn't feel it necessary to confirm those that were indicated as having been collected.

Q. Now, I understand there are several methods of confirming receivables. First, the positive method whereby you get an answer, or try to get an answer, from as many of the customers as is possible; second, a positive confirmation of either a fair sample or all the large accounts and a sample of the rest, and finally, a negative confirmation in which you don't expect to get an answer unless something is wrong. How do you feel about the relative value of those methods?

A. You mean the relative value in relation to cost?

Q. Can we do it both ways? Could you indicate the relative cost of the three methods? Which would be most expensive?

A. Well, the second one, positive confirmation of a fair sample of all the large accounts and a sample of the others, would probably not be very costly and would be reasonable; circumstantial evidence as to the remaining accounts.

A negative confirmation of all accounts would not be very expensive, nor, in my opinion, particularly valuable. I say particularly valuable, it has quite a value but it has not as much value as a positive confirmation.

Q. And you would say it is better than nothing, though?

A. Better than nothing. Positive confirmation of a large group of accounts is quite an expensive process.

Q. We were speaking a moment ago of the effect of payment before you complete your audit on the desirability of confirming. I am not quite clear. Suppose you are confirming accounts as of December 31. Would the number, or percentage, that are paid up between January 1 and February 15, we'll say, the time at which you come into the audit, have any bearing on your decision as to whether the accounts outstanding as of December 31 should be confirmed?

A. I think your decision as to whether the accounts at December 31 were to be confirmed would be long before February 15. It would probably be made and done within a day or two of December 31. As a matter of fact, you usually could not consider—you could not get confirmations from customers, I don't think, to any extent, if you send out the requests 6 weeks after the date of the accounts you wish to have confirmed.

I think if accounts are to be confirmed, they might better be confirmed some other date than December 31. The surprise element comes in.

Q. And now, at page 8 of this pamphlet, and again at page 34, under accounts receivable, there is a reference made to safeguards surrounding the handling of incoming mail and remittances and to the mailing of monthly statements to customers. In this connection, what inquiries or tests would you make to see that such safeguards are established?

A. Well, if incoming mail was controlled, and the receipts listed at the time the mail was opened, we sometimes will check the preliminary lists later against the cash book. Make some test checks. That would indicate to us, of course, that lists had been prepared.

Q. I see.

A. Mailing of statements to customers. That is another example of these exceptional steps which indicate a lower proportion of checking than the general program set forth here. It is also a reduction rather than increase the other way.

Q. I see. Now, on page 34, a reference is made that you can make a relatively limited test of the individual customers' accounts:

If there are large numbers of customers and the customers' ledgers are kept by employees who do not have access to incoming cash or cashiers' records, who do not mail out the monthly statements, nor initiate credits for returned goods or allowances, a relatively limited test of the individual customers' accounts may suffice.

What do you indicate by, "a relatively limited test" there? What is meant by that?

A. Well, that relates to some of the tests made by the auditor which are directed to the disclosure of irregularities. For example, the approval of credits to customers, the approval of bad debts written off, inquiries with regard to claims, and so on.

Q. Now, if you should determine not to confirm the accounts receivable, would this control your decision as to whether to confirm notes receivable which arose out of open accounts?

A. Generally; yes. In that case you would inspect the notes. That is a little more confirmation than you have on the receivable, but you would not usually confirm.

Q. You would not usually confirm them? At the bottom of page 33 it states that:

Large installment companies have thousands of notes receivable which are controlled by a satisfactory internal check.

Would you consider it desirable to confirm them under those circumstances?

A. No.

Q. What is meant by, "Satisfactory features", in the system of internal check in that regard?

A. There are two or three questions on our questionnaire on internal control of notes receivable, the answers to which, I think, would answer your question:

How often are notes balanced with the control accounts and by whom are notes and related collateral inspected by the company's auditing staff? If so, at what interval?

Who are the authorized custodians and others having access to notes and collateral?

Do custodians control or have access to accounting records?

Q. Did you have something further on that question?

A. No.

D. INVENTORIES

Q. I am sorry. Now, turning to inventories, Mr. Broad. In your opinion, is an accountant responsible for pricing of inventory in accordance with generally accepted accounting principles?

A. I would say he is not responsible for pricing. I would say he is responsible to satisfy himself.

Q. That is the mechanical details of making the first pricing, the accountant would not do?

A. No.

Q. But he would satisfy himself that pricing was made in accordance with accepted accounting principles?

A. Yes, sir.

Q. One of the commonly accepted methods is perhaps cost or market, whichever is lower. What is meant in that case by market price in your opinion?

A. The price at which the company could buy the relative quantities from sources to which it had access and from which it customarily can or does buy.

Q. What do you, or what procedures do you follow to determine that market prices used are actually applicable as to grade and quantity and other circumstances of the type of purchase?

A. The invoice costs of current purchases is probably as reliable a guide as any unless there has been a marked change in the market within a few weeks. For commodities—quotations are quite reliable

for commodities that are freely dealt in, such as wheat or sugar or cotton and perhaps packing-house products.

Another measure is selling price, less the allowance for selling, administrative expenses, and a margin of profit. Selling prices subsequent to the date of the inventories.

Q. If you used any quoted prices, do you follow any procedure to ascertain whether or not these other conditions are pertinent? That is, quantity, grade, credit, terms, and so forth?

A. Would you read that question, please?

(Whereupon, the reporter read the last question.)

A. If the company is buying in the open market, I think those quoted prices would be applicable. If you are buying pig iron by the carload lot, for example, quoted prices would apply there. If you are buying a small quantity, they wouldn't.

Q. Now, turning to items 9 and 10 under the inventory procedure, what procedure do you follow in determining that goods held or shipped to the company on consignment are properly treated in their inventory?

A. Goods shipped on consignment, first you would want to find out that they were not included in the accounts receivable, but they were included in the inventory.

Q. How would you go about doing that?

A. They would appear, as an asset, somewhere on the company's books, as goods under "Goods on consignment," or "Accounts receivable." In the latter case you would determine it by going over accounts receivable with the credit man, manager, or somebody else. If it is carried as a separate item on the company's books, it is comparatively simple. Goods held on consignment, the difficulty is to determine that the company owns the goods which are included in its inventories. For that, I think you usually rely on your inventory control or on the stock records which form a check on the listed inventory taken by the company's employees. Goods not owned could not ordinarily find their way into the inventory control or into the stock records.

In addition, it is our practice to obtain a certificate from the responsible official with regard to ownership in addition to what inquiries we make ourselves. It is a somewhat difficult problem.

Q. Where you discover that goods have been shipped by the company on consignment, do you attempt to confirm that direct from the consignee?

A. If the item is relatively important. Otherwise, you would be prepared to accept the regular monthly signed statements from the consignee.

Q. I see. How do you determine that the goods actually, said to be on consignment, have actually been shipped? Do you make any tests to determine that?

A. I think that the fact that the consignee acknowledges that he has received and holds the goods, we usually accept.

Q. You would accept that?

A. Yes.

Q. Now, what procedure do you follow to determine that there have not been included in sales, goods which were shipped during the subsequent period to that under review? What evidence do you rely on there?

A. Well, we usually stress what we call the cut-off date. That is the date before which all shipments are taken out of the inventory, and after which shipments made do not come out of the inventory. We make some check of a few days' shipping records, both before and after the balance sheet, to the record of shipments billed. Here again it depends upon the size of the organization, and so on.

Q. What evidence do you rely on that shipment was made or was not made?

A. The shipping record, which is an official document, and is usually a numbered document, controlled, signed, and dated.

Q. You mean by official document, regular document of the company?

A. Yes.

Q. Do you examine any other supporting evidence?

A. As a rule, not.

Q. Suppose the goods are carried outside of the—in warehouses or other places beyond the immediate plant; how do you determine it in that case, or is there any special determination made?

A. You mean if a company has two plants, and the second plant—the procedure would probably be the same as in the first.

Q. Suppose it is under someone else's control. Let us take an independent warehouse over which the company has no control. How would you determine that goods had actually been shipped in that case?

A. Well, instead of having the signature of the company employee who shipped the goods, I would have the signature of somebody on the outside, who shipped the goods.

Q. That signature would appear where?

A. On a report from them that they had shipped the goods.

Q. Would that be an individual report as to each of the items, in order to correlate it with the cut-off date?

A. On goods in outside warehouse, I would probably have my own stock records, controlling those goods, and on those I would enter reports of shipments.

On the other hand, from the outside warehouse, I would have the reports of shipments, and a statement of what is left on hand at the end of the month. One acts as a check on the other.

Q. I see. Do you make any verifications of the accuracy of inventory footings and extensions in the inventory records of the company?

A. Oh, yes.

Q. Do you use comptometer operators for that?

A. Where the volume of work is large, it is almost essential to use a comptometer operator.

Q. Would you say that was a desirable practice or not?

A. As a practical proposition, today, it is almost essential. It possibly has certain weaknesses, but I think you can overcome them.

Q. Would you indicate what the weakness might be there?

A. Well, comptometer operators are usually temporary help. To some extent there is not the same possibility of checking their work, unless you want to use one comptometer operator to check another.

Q. Is that done?

A. Only where you perhaps have reason for question. I think of one case where the operators were not finding very many errors, and we wondered why. We kept a record of them, to see whether one

was doing better than the other. We did a little cross-checking. It developed that the company had checked and cross-checked so many times before we got there that there were no errors.

Q. I see. Now, what inquiries or tests do you customarily make to determine that purchase invoices for stock included in inventory have been entered on the books?

A. Well, primarily, you have the inventory control, which may be on the basis of stock records, or may be on the basis of a cost system, tied up with the general ledger controlling account.

If there are differences between that and the physical inventory that is made, they have to be traced down. Invoices for stock included in the inventory not entered up in the books would result in a difference between the stock records and the physical inventory.

That is just a general over-all check. It is customary to review invoices subsequent to the date of the balance sheets that have gone through the purchase records, or whatever they do go through, or on hand if they have not gone through any records, to see from the receiving slip what date the goods were received.

If they were received before the end of the year, you would naturally have to make an adjusting entry for them. Sometimes you will check a few of the larger items in the receiving records, toward the end of the year, to see that invoices have gone through for them.

In the case of a commodity business, you could perhaps check your total commodities, in total for the year, reconcile the opening figure with the end of the year figure, with the invoices that have gone through the year. These are just indicative of the kind of checks that an auditor can and does make, depending on the circumstances.

Q. That is, he would adapt his checks to the circumstances that he found?

A. Yes.

Q. I see. Now, suppose that you have completed, as to inventories, the procedure which this bulletin outlines, to your own satisfaction. Do you include in the accountant's report, or the statements, a qualification as to your responsibility for the quantity, quality, or condition of inventories?

A. We do not include it in our report. We request the company to state in the statements how the inventory was determined.

We regard the statements as the statements of the company, and any indication, any comments made on those statements are comments by the company rather than a qualification by us.

Q. You do not feel that that is a qualification on your responsibility?

A. No; although it is our custom to ask the company to put it in there.

Q. Now, do you feel that the inclusion of such a statement on the part of the company relieves the auditor of the necessity of making such tests and inquiries as are indicated by the last sentence in item 3?

That sentence 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. Well, the auditor should certainly make such tests and inquiries.

Q. That is, whether or not that appears—

A. Yes.

Q. He makes the same test?

A. That doesn't make any difference.

Q. What tests and what inquiries does this sentence contemplate, Mr. Broad, in your opinion?

A. That is a large order.

Q. Well, let us say this now: What sort of test does it contemplate?

A. I think I can answer that question by reading a few items from our Guide for Preparation of Programs.

Your question divides itself into two. First, was quantities. The first item you referred to was quantities.

I will read these items:

Obtain a copy of the company's inventory instructions, and compare with the instructions at the beginning of the period. Make notes of any material changes.

Review the procedure for receiving, recording, and issuing stock.

Prepare comparative schedules showing amounts by which the book inventories at the beginning, during, and at the close of the year were adjusted to physical inventories. Explain material differences.

Test the final inventory sheets by comparison with the originals, and with tickets, cards, or other means used in recording the original count.

Reconcile, if possible, quantities in inventories at balance sheet date with quantities in inventories at opening date.

Make a test comparison of the inventories with the stock records, in support of quantities, prices, and values. Investigate differences.

That is indicative of the kinds of checks you can make as to quantities, depending on the circumstances.

Now, with regard to quality and conditions:

Obtain or prepare if practicable statements showing number of months' purchases, or production in inventory, and discuss any item which seems abnormal.

You would ordinarily obtain that from the stock records. It gives you an idea as to whether there was slow moving stock:

Inquire if company has discontinued any products, and consider reserve for anticipated loss.

That is particularly applicable in the case of style goods:

Apply gross profit tests by departments, or major products, if possible, and compare gross profits with that of previous periods.

The result of tests of this kind will give you a basis on which to go further, if you want to, or to form some kind of a general opinion as to whether these questions of quality and condition have been adequately considered.

Q. May I inquire who would make these tests? That is, the survey test that you have been speaking of, such as the gross profit—would that be the supervisor or senior in charge, or the partner?

A. It would probably—

Q. Or collaborator?

A. The senior or supervisor. It might be reviewed by the partner.

Q. It might be reviewed?

A. If it were not made up by him in the first place, to get their departmental check would be quite a task, unless the figures were readily available. They would have to be obtained as a special item to get them, for the partner to obtain them.

Q. Is that guide your own guide that you are referring to there, Mr. Broad?

A. Yes.

Q. It is not a public document?

A. No.

Q. Now, you mentioned that you would review the methods of taking inventory that the company follows. Would you indicate the important features of what you consider to be a satisfactory method of taking inventory, speaking now of the client's taking of the inventory?

A. Yes. A lot depends on the class of the business, but take a manufacturing concern: Usually there is one group of men that will go around and list the merchandise, and put it down on tags, which they will initial.

Later, another group, independently, will go around and check that, and perhaps then, or at a later time, somebody else will come and list those tags.

Of course, that second check is the real inventory check on the first one. If there are differences disclosed, sometimes they will have a third group to check those.

At each different step, each man doing a particular piece of work should initial or sign for the work he has done, for his responsibility.

Q. Is he supposed to know what—take the case of the counter: Is he supposed to know what the first crew found as the count when they made the first check?

A. It would be better if he didn't, but usually he does. Also, I would say that it would be better in theory if somebody entirely out of the particular department took the inventory of that department, but in practice, I don't think that would work out, because a man from another department would not know what the goods were.

Q. How do you establish the fact that the client has observed these points you are mentioning? What do you rely on there?

A. Well, in the past we relied more or less upon the signatures for the different operations on the sheets. Recently, I have in one or two cases tried out a procedure to see whether it is practicable, of talking to one or two of the people who have done the work, to see what they did, and how they did it; also, to make a check to see that the people whose signatures appear, or whose initials appear on the sheets, are actually on the pay roll.

That is a recent development. I do not know how far it will be adopted, or whether it will be adopted.

Q. Just this year?

A. Yes.

Q. Now, suppose that you find that the methods used by the client in taking its inventory are wholly unsatisfactory, what do you do under such circumstances?

A. Well, there have been cases, I think, where we have required a second inventory. That would be very extreme.

Q. Would you supervise that inventory yourself in that case?

A. No; not necessarily. Carelessness does not mean dishonesty. We would want to offset the carelessness.

Q. Now, in your answer—

A. Perhaps I could expand that last one.

Q. I beg your pardon.

A. In a case like that that you have mentioned, the auditor has something besides a physical inventory to go on. If he has, he can rely perhaps on stock records, or on tests, to satisfy himself, except

in a very bad case, whether the inventory is substantially correct, even though it may have been carelessly taken, or may not have had the usual steps of internal check and control applied in its taking.

Q. I see. Would you in such cases, then, make any special qualification of your accountant's report, inasmuch as the inventory system was not particularly good, or would you simply go ahead until you were satisfied that the figures were substantially right?

A. I think, if it is a particularly bad case, you would qualify your report, or perhaps not give a report until you had a satisfactory inventory. From that extreme down to where you have an accurate inventory, there is a long range, and you have to draw the line somewhere on that range.

Q. I see. But if you—can we put it this way: That you either satisfy yourself or put a clear qualification in your report?

A. Yes; of course, there are different degrees of satisfaction, too.

Q. Now, in your answer to one of the earlier questions, you stated that you would examine the methods of shipping, receiving, and stock-keeping. What would you say would be a satisfactory condition to be found here? That is, does the segregation of the duties in regard to these matters—is that of importance?

A. I think it would be better if the stock-keeping department did not have any part in receiving or shipping stock, if it was truly independent. That, of course, is impossible in a small organization. In a small organization, the same man may be shipping and receiving goods, and somebody in its employ, under him, keeping the records.

Q. Would you vary your checks if you found that condition existing?

A. I think you would not rely on the stock records to the same extent.

Q. I see. Now, do you expect the man or the men who work on the inventory to be reasonably familiar with the products of significance in that inventory?

A. Yes; as accountants.

Q. As accountants?

A. Yes.

Q. What does that mean—as accountants?

A. Well, I think that an accountant usually obtains a certain amount of general information about the product of the company with whom he is dealing, but his knowledge is the knowledge of an accountant and not the knowledge of a merchandise specialist.

Q. Could you explain just what you have in mind there a little more fully? What do you mean? What is the knowledge that an accountant has? Put it that way.

A. Well, I am charged, let me say, with the responsibility of checking prices of a steel inventory. I want to know generally what processes the raw material goes through until it comes out as the finished product. That is very general knowledge.

I perhaps see the machinery, and at least some of the different—some of the material in its different stages. When those goods are listed on the inventory, I need to know at what stage they are, and I need to be able to intelligently check the cost records up to that stage.

That does not mean that I know a piece of finished steel is good

or bad, has a crack or a flaw in it, that it is of certain constitution, and things of that kind.

That applies more particularly, I think, in style goods than it does in perhaps the steel industry.

Q. I see. You are using that, the steel industry, as an example, and I presume you would have the same things in mind, or comparable things, as to other industries?

A. Yes.

Q. I see. Now, is it your practice to make spot tests of the physical quantities of the inventories under any particular circumstances?

A. Not as a requirement.

Q. Not as a requirement?

A. In some cases we do do it, in cases where we think we can properly do it, and have the necessary knowledge to do it.

Q. What do you mean by the necessary knowledge?

A. I know a pair of shoes when I see it, where I might not know some other product.

Q. You mean in those cases, you feel that you could satisfactorily count the pairs of shoes?

A. Yes.

Q. But without determining that they were——

A. Saleable, or otherwise.

Q. Mismatched, for example, in each case?

A. That's right, or that they were up-to-date styles, as distinct from something that is a year old.

Q. You would expect to be able to distinguish obviously out-of-style merchandise—for example, high buttoned shoes in great volume, or something of that kind?

A. Yes; or red pumps.

Q. Do you make any—is it your practice to make any over-all tests of the reasonableness of inventory quantities? For example, by comparisons with warehouse capacities, average consumption, trade statistics, imports, tax payments, insurance coverage, and so forth?

A. Yes; I would say yes to some of them, and no to some others.

Q. Will you indicate that please?

A. Warehouse capacities—I would rely more on a test as to the amount of inventory in relation to the business being done than I would to the size of the warehouse. I don't think I have ever related it to warehouse capacity. I am speaking now personally.

Average consumption and purchase—I think you direct that to the particular business, do you not?

Q. Yes.

A. Yes; I have used that in some cases, particularly where commodities were involved, where it could readily be done.

Trade statistics of production—I do not think I have ever run across a case where the company does such a large proportion of business in a particular line of business that that would have applied.

The same applies to consumption and imports.

Tax payments—I do not regard them as a reliable check on inventory quantities.

Insurance coverage—yes; particularly small and moderate-sized companies.

I think that covers your question.

Q. Yes. Earlier you referred to the use of the gross profit test as a method of checking up on some of these factors. What exactly do you have in mind when you are using that test? What are you trying to bring out?

A. Well, if the company shows greater gross profits this year than it did last, let us say, I wonder whether that is because the inventory is overstated, and if cost of sales is understated. If there is an indication that the inventory may be overstated, it is worth looking into, to get a satisfactory explanation.

Q. Is there any other purpose that it serves there?

A. Why, I think your further inquiries give you somewhat of a general picture of the business, whether it is more profitable than it was, or less profitable.

Q. Do you attempt to trace back, if those things are uncovered, for example, that a business has become distinctly more profitable or less profitable?

A. Well, in a grocery business, for example, if you are working in it for 2 or 3 weeks, you have a general idea whether prices have been increasing or going down, from how the people talk generally, and your average gross profit may be 1 or 2 percent more, and it may be very readily accounted for.

Q. Do you apply the same test, say, as to the volume of sales, if they show a large volume of sales on their records, and you are in there, and there does not seem to be much business done, from your examination.

You just indicated that you take notice of the fact that prices have gone up or have gone down. Do you do the same thing as to volume?

A. I think so, yes. You know whether business is—you get a general picture as to whether the business has been good or has been bad by the way people talk—their mental attitude.

Q. Now, turning to inventories that are not held at the principal place of business, or under the company's control, what is your procedure of verifying the quantity of merchandise held in independent warehouses, or in the vendor's establishment?

A. Direct confirmation in each case.

Q. Do you require financial responsibility in such cases?

A. I would not.

Q. Or evidence of them?

A. It would depend, of course, on the materiality of the item.

Q. Yes, I mean only significant items.

A. If the goods had been paid for—of course, there the question of financial responsibility comes in. If they have not been paid for, if they have been just billed, of course, you would not worry about financial responsibility. If they couldn't ship the goods, and you haven't been paid for them, you have lost nothing.

Now, in cases where goods have been paid for, and held to very material extent at somebody else's warehouse—that is somewhat unusual. I think the first one I came across was within the last 6 months, where it ran into several million dollars, and in that case I wanted to find out about the financial responsibility, but that was—it is an unusual situation.

I would not say that I have ever run across it personally before, or that there is any general practice with regard to it.

Q. I see.

The EXAMINER. How did you determine the financial responsibility?

The WITNESS. I went to one of the officers and asked about this company, and it was obviously a company which might not have the financial responsibility, and the outcome was that its parent company, which was responsible, guaranteed the account.

Q. Suppose you accept merely a confirmation: Would that procedure disclose whether the vendor had misappropriated the merchandise?

A. No.

Q. It would not disclose that?

A. No, if he had misappropriated it, he would not tell you so.

Q. That is what I had in mind. You mentioned in this case you were just citing that the parent company involved was responsible. How was that determined? I mean, how did you determine that? Was it just a company you knew sufficiently?

A. It happened to be a company that is known nationally.

Q. I see. And you had no question as to its responsibility?

A. That is right.

Q. Now, looking to the future, Mr. Broad, taking into consideration all of the things which we have been discussing for the last while, what procedures do you think auditors should use in verifying the quantities, quality, and condition of inventories?

Would you emphasize any of these steps particularly that are included in the bulletin, or would you add any new ones?

A. I think I wrote something down on that question, which I can read to you.

Q. If you will, please.

A. Accountants are giving considerable thought to improvements and possible extension of their procedures, particularly with regard to inventories.

It is probable that more attention will be given to methods of taking the inventory, and to the effectiveness of the internal check and control, as applied while the inventory is in process of being taken.

Some spot-check that the quantities exist is undoubtedly practicable, but however extensive this might be, the auditor, who is skilled in accounts, is not qualified by training or experience to assume responsibility for the quality, description, condition, and saleability of the merchandise.

While he can take steps to assure himself that certain quantities of merchandise are actually on hand, it would be unfortunate if the fact that he took those steps should give the person reading his report a feeling of greater assurance than the facts justify, or should invest the statements in his report, in the words of one of our financial papers:

With a significance which they neither claimed, nor in fact possessed, nor were designed to offer.

A procedure which might be practicable, except in the case of the very large corporations, would be for auditors to be present at the time of taking the inventory, to see that a plan of inventory procedure, carefully thought out and established, had actually in fact

been followed; in other words, to undertake general supervision at the time on the spot of the method of taking the inventory, as distinct from a physical check.

Another plan which has been suggested is that auditors should encourage throughout the year the continuous taking and checking of parts of the inventories against stock records, or other book records, by employees independent of the stock-keeping departments, and the auditors should follow up the reports on these partial checks.

I mention these suggestions, not because I think they will necessarily solve the problem, but as indicating that auditing procedures are being carefully considered within the profession. It would be inadvisable to make a hasty and ill-considered revision of procedures, or to go to an extreme.

The problem is to develop existing procedure, so as to give in added safety, some return commensurate with the increased costs, and perhaps to make a fuller disclosure as to what those procedures are.

The selfish interests of accountants might be served by insisting on a very much more elaborate program before giving an unqualified report. From a professional standpoint, I believe this would be short-sighted, because, in the long run, what is in the public interest and beneficial to business will be in the sound interests of the profession.

(Discussion off the record.)

Q. Mr. Broad, in several of the Commission's forms, we asked for the basis of determining the amounts at which various assets are carried. One of those is inventory. Would you say that the phrase, "Cost or market" has any weakness from the investor's point of view, as to just what it means? Is either—are there several methods of determining costs?

A. Yes; there are, and they vary widely, of course, as to the resulting figure which will appear on the balance sheet. They do not, I think, vary so widely with the resulting figure which will appear on the profit and loss account, as long as they are consistently applied.

Q. From year to year?

A. From year to year. For example, you may take cost or market with regard to each individual item, or you may take the aggregate cost and the aggregate market, and take the lower of those two. That would make quite a difference on the individual balance sheets, sometimes. I think, where there is so much variety of practice, which may result in different figures, or profit being shown—

Q. Would you go further and say there are a number of different methods of determining what the cost is? For example, last in-first out, as opposed to first in-first out?

A. Yes; different methods of applying overheads on cost.

Q. Would that make a significant difference in the figures?

A. Yes.

Q. Which of those you used?

A. Yes. In the balance sheet particularly.

Q. Yes; I am speaking of that.

A. It might in the profit and loss, but I don't think it is relatively so important there.

Q. I see. Is the same true of market?

A. I don't think to the same extent.

Q. To a lesser extent, but still present, or is it not present at all—this ambiguity?

A. There is some difference of opinion as to what constitutes market in a particular situation. Sometimes some people think it is selling market and others think it is cost market. They are two quite different markets.

Q. Is it sometimes the selling price less cost of selling—selling expenses? Is that what is meant by markets in a certain case?

A. Well, my preference would be to take off in addition some provision for profit.

Q. Yes; excuse me.

Mr. WERTZ. May we recess until a quarter of two?

The EXAMINER. Yes; we will recess until 1:45.

(Whereupon an adjournment was taken until 1:45 p. m.)

AFTERNOON SESSION

E. OTHER BALANCE SHEET ITEMS

Q. (By Mr. WERTZ.) On page 21 of the bulletin, Mr. Broad, in item 4, how do you determine that amounts capitalized as additions to plant, that is, to fixed assets, represent real additions or improvements?

A. Where the authorizations do not specify whether it is a repair or replacement or an actual addition, there is usually some description as to what it is. It calls for an exercise of judgment in each case to determine which of these classifications it comes into, and even though the authorization did specify it would still require that exercise of judgment.

Q. Do you rely upon what is stated in the authorization or do you make any physical inspection?

A. As to work which has been done?

Q. Yes.

A. Generally, we rely on what is stated in the authorization. In a major case, you might make some physical inspection, but that would be unusual.

Q. I see. Referring to the bottom of page 34, how do you ascertain that plant units have been abandoned and should be removed from the asset accounts? What is your procedure in that connection?

A. Well; you could only do that directly by taking inventory of the plant which, of course, is out of the question. You have to rely on somebody, usually a responsible person, preferably the plant superintendent, or chief engineer, who will assure you that all the items have been properly reported.

Q. But you make a specific inquiry in connection with that and then rely upon it?

A. Yes; specific inquiry, yes.

Q. Now, suppose from the book records there are disclosed assets which are nearly depreciated, that is, almost completely depreciated, would you make any special check of those to determine whether they have been abandoned?

A. No more than of the others. You sometimes find assets fully depreciated carried on for years thereafter. In that case you give them some special treatment.

Q. Now, on page 23 in item 2, there is a reference to the insurance charges. What procedure do you follow in verifying the allocation of insurance costs between the current year and the future years?

A. It is a mathematical calculation based upon the period of the policy and the proportion which has expired against the proportion which is yet to run.

Q. How do you determine, or how do you get your information on that?

A. By looking at the policies.

Q. What do you do with it?

A. You take the amount of the premium and the period covered by the policy and those two give you your calculation.

Q. Do you use your examination of the insurance policy and the supporting records for any purpose other than this allocation?

A. In small, moderate-sized examinations, we use it to determine whether the company was reasonably adequately insured.

Q. As to what type of assets?

A. As to the type of assets that were insurable; against fire.

Q. Against fire?

A. Yes.

Q. And now, if you had a large corporation, Mr. Broad, would you change that policy in any respect? What would you do with the insurance in such cases?

A. Well, if it was large enough to have a separate insurance department, it would presumably have a very large number of insurance policies, or blanket policies covering properties all over the country. To some extent you would rely upon the competence of the man at the head of the insurance department. You might accept his summary as to the insurance carried, or you might accept his summary as to the premiums and so forth, just making some clerical check of the computations.

Q. You have mentioned that in the case of a small company you would be concerned to see whether their assets were adequately insured?

A. Usually when we give a detailed report on a small company, we give a comparison of the insurance carried for fire against the insurable assets.

Q. You would not do that for a large corporation?

A. I think if we were giving a detailed report of a large corporation, we might do it, but state that it was based upon the company's records.

Q. I see. Well, now, you have indicated that you would get this information from them but would you, yourselves, give consideration to the information you got from the company records as to whether the assets were adequately insured or whether there may be an inherent loss in some of the assets?

A. Well, the term "adequately insured," presupposes an exercise of some judgment and some knowledge. Some assets are not insurable, they don't need insurance. The company may carry self-insurance to some extent. All those things come into determination of whether they were adequately insured.

Q. Well, would you, as an accountant, give consideration to those factors in connection with your study of their insurance?

A. Yes, yes. You said "study of insurance." I don't know what you mean by "study" exactly.

Q. Excuse me. What I meant by study, such work as you do in connection with the allocation of charges or other parts of work?

A. What I have in mind, as to work that you do, is work as an accountant rather than as an insurance expert.

Q. Yes. Now, you indicated in your answer that you would rely, in the case of a large company, to some extent on the insurance department. Do you mean that you would rely upon them as to the accuracy of the records?

A. No, what I meant, rather, is this, that in a large company you have inventory all over the country. You have plants all over the country. It would be quite a task alone to list those plants and those inventories by location. That might be a day's work; several days' work, and then to segregate the insurance against that. It would be quite a task. Now, ordinarily, in a large company where there is an adequate insurance department, the auditor would not undertake that work.

Q. Would he just get the records from the insurance department and proceed from there?

A. I think he would be apt to get the records more in total than in detail.

Q. But, then, he would subject those records to consideration such as you have mentioned earlier?

A. Yes.

Q. Now, on page 24, again in item 2-C, under accounts payable, it is suggested there that the accountant make a test examination of the monthly statements received from creditors having large balances. What do you consider to be an adequate test in that connection?

A. Well, you perhaps notice that that paragraph is stated in a different manner than most of the other paragraphs here. Most of the other paragraphs are stated in the imperative, obtain, do this, do that. This paragraph is suggestive more so than the others:

The following procedures are helpful in determining that all liabilities are included in the accounts.

I think there is a degree, intentionally a degree of, perhaps less suggestive here than in the other cases.

Now, as to the extent of the test, it would be a minor test usually. It is a very common practice for a large corporation, a corporation not necessarily large, but having a lot of creditors to check these statements themselves, and throw them away, not retain them. In that case, I don't think you would be necessarily very much concerned if there was that general practice.

Q. On page 8 there is a phrase there which states a requirement as to the approval and entry of vouchers being made by others than the disbursing officer. What is the significance of that?

A. Well, that ties in with what I said before, that if a number of persons participate in the initiating, carrying through and recording a transaction, the presumption is that the transaction is a real one. Here you have two different individuals, at least participating in the disbursement. One approves and another one pays it.

Q. Suppose the same person approved it as paid it?

A. Then you would not have that same degree of internal check.

Q. Would that alter your examination?

A. It would depend to some extent on how many other people had part in the transaction. It is not unusual for a comptroller to sign

the great bulk of checks in a corporation. I don't think it is necessarily the best practice, but it is very common.

Q. Now, do you expect the members of your staff to have a general knowledge of the various types of taxes which bear upon particular business?

A. The main taxes; yes. The miscellaneous general taxes, not necessarily. You would have a general knowledge of them, but there are thousands of taxes throughout the country so that no one person, even an expert, could keep them in mind.

Q. What do you refer to as main taxes?

A. Federal taxes, State taxes, particularly taxes on income, capital stock taxes. I do not refer to local and excise taxes that are imposed by local municipalities.

Q. Does that extend to foreign countries?

A. Pretty much, yes. I would say, generally, he should know whether there is an income tax. He should find out how it is calculated.

Q. How about property taxes, are those one of the types you call main taxes?

A. I think most people know that there are property taxes almost everywhere you go.

Q. Now, coming to contingent liability. What procedure do you follow to determine whether there are any contingent liabilities and what the amount of them is?

A. That is one of the most difficult problems facing the accountant. It is a matter of dealing with something that is not on the records as distinct from something that is. Finding something that is not readily determinable sometimes. One of the steps, of course, is to go through the minute book to look for guarantees of securities of other people. Another step is to write the company's attorney or inquire of the company's attorney as to what litigation might be in process. Commitments is another prolific source of inquiry. We have more or less a standard list of things which we wish to consider or make inquiry about. We know generally where is the best place to find them, and after making those inquiries we usually get a letter of confirmation from our client and on that letter of confirmation we have listed for his consideration, so that he will understand what we are after, the type of items which we have in mind. The list is not a comprehensive list, notes or trade acceptances, discounted or sold, accounts receivable assigned or sold, judgments under appeal, lawsuits instituted or pending, additional assessments, levied or pending, of Federal or State taxes, guarantee of bonds, or interest on bonds of other companies, guarantee or endorsements of notes of other companies, firms, or individuals. Generally we know where to go to get the best information on those matters. Sometimes we go to the bank for notes receivable discounted. We know if property has been sold, subject to mortgage, it would be recorded, and we know whether a mortgage is still outstanding or we could find out. The matter receives a great deal of consideration.

Q. Would you say that the presence or absence of contingent liabilities is one of the important features in the balance sheet, would it have a very material effect on it?

A. I would say it is very important; if there are material contingent liabilities, they should be stated.

Q. What I meant to say is that an important place where you need information to prevent the balance sheet from being misleading; that is, information as to contingent liabilities?

A. Yes; quite. I might say that I would exclude from the contingent liabilities the normal cost of routine things like a lease or some things like that, or a commitment where there is no probable loss on it. There are contingent liabilities in the ordinary course of business on which no loss is anticipated and it is not usually necessary to mention those.

Q. What responsibility do you feel an accountant assumes in this connection?

A. To make reasonable inquiry in accordance with standard accounting procedure.

Q. If he has made such inquiry, would you feel it still necessary to qualify his statements; that is, include qualification in the certificate?

A. No; not unless you don't trust the people.

Q. In that case, of course, you would?

A. The president might have endorsed a note. You could never find that out.

Q. Until it was too late?

A. Until it was too late, that's right.

Q. You mentioned earlier, in connection with this point, that you would consult the corporate minutes. Did you have in mind there the stockholders' meeting minutes, or the directors' meeting or operating committees, or what?

A. Well, more particularly for contingent liabilities, the directors' minutes.

Q. Do you examine these other minutes as part of your regular auditing procedure?

A. Yes; except that there might be cases where there are advisory committees which have, under the bylaws, no specific powers, and in those cases you perhaps would make rather a cursory examination.

Q. But if possible you would examine them?

A. Yes; we prefer to.

Q. Now, turning to the profit and loss statements—oh, one thing further, Mr. Broad, in connection with contingent liabilities—would you examine the contracts which the company has?

A. Yes.

Q. Would you consult legal counsel on some of those, if they appeared significant?

A. Usually, no. An accountant can understand a contract.

Q. If you were in doubt, what would you do?

A. Consult an attorney.

F. PROFIT AND LOSS ITEMS

Q. Now, turning to the profit and loss procedure, if you look at page 30, item 1, there is a suggestion there that a working profit and loss statement be obtained, or prepared, in such detail as is readily available.

For this purpose, do you prepare your own statement, or do you utilize the financial analyses that the company has prepared?

A. In most small cases, or moderate sized cases, we would prepare our own. There would be no objection to using one prepared by the company, provided it had been checked against the records so that it was really the accountant's own statement when he got through with it.

Q. Would you make inquiry to ascertain whether they had those?

A. Yes.

Q. If you wished to use them?

A. Yes; with the idea of saving time, more than anything else.

Q. That is what I had in mind. Now, in item 2 on that page, there is a suggestion that the auditor obtain budgets, previous annual statements, and monthly financial statements. What is the purpose of getting those?

A. A very important part of the accountant's examination of an income account comes from what we might call an analytical review, and a survey of the figures, in comparison to the operations for the year, and in comparison with previous years, and in comparison with predetermined amounts. Any big discrepancies, one way or the other, will stand out like a sore thumb, and those are what he investigates.

Q. You say, "he investigates." What would you have in mind there?

A. Well, if legal expenses are twice as much as they were the year before, he would want to look into that. If repairs were very much lower, he would want to look into that—things of that nature.

Q. What would you do in looking into those? Would you try to trace them back?

A. I would try to see what was in last year, and what was in this year, and make a comparison to see whether something in last year was left out this year, or vice versa.

Q. Well, is it just for the purpose of finding out whether the records are accurate, or of explaining to your own satisfaction the causes for the difference?

A. Well, I think the two are tied up together, if there is a satisfactory explanation, you have satisfied yourself that the records are accurate to that extent.

Q. Now, under item 3, as to sales and cost of sales, there is a procedure outlined for testing allowances to customers for returned merchandise, claims, and rebates. What is the importance of such an analysis? That is the last two sentences of that item.

A. That is part of what you might call the fraud portion of the audit. If allowances are made to a customer's account, they might be used to cover up improper extraction of funds. You want to make sure that allowances could not get in there that do not belong in there.

Q. In making up these tests, what exactly do you do?

A. You call for some of the credits, and for some of the supporting papers. If it is return goods, you will see a receiving slip that the goods have come in. If it is an allowance on price, you will see the authorization or approval of somebody who is authorized to give that approval.

Q. And satisfy yourself that they have been made in accordance with the system of the company?

A. Yes.

Q. I see. Do you always make such a test?

A. In small and moderate-sized companies, I think; yes.

Q. As to larger ones?

A. It would depend upon the extent to which they are checked within the organization.

Q. In the case of a larger corporation, is it your thought that you might find a system of internal check which was sufficiently foolproof in your opinion to avoid the necessity of this test?

A. That is right, they might have an internal audit staff that checks every one of them. In that case, you would probably do nothing.

Q. That implies that you would satisfy yourself as to the audit staff?

A. That they were doing it; yes.

V. REVIEW OF THE ENGAGEMENT

Q. Now, I would like to turn to the question of reviewing the original materials which your audit program developed, and pulling them together in the form of financial statements.

In your practice, Mr. Broad, who is responsible for drawing these things together?

A. In the first place, the senior accountant.

Q. By that you mean whom?

A. The man in charge of the job, who is sitting down and doing the field work in the company's office.

Q. What does he do? Does he pull all these together, and make up a tentative set of statements?

A. He starts with a trial balance, classified in some form, and he makes his adjustments, and finishes up probably on the same sheet with his balance sheet. He has all his working paper supporting that. When he has prepared all his working papers, and satisfied himself as to all the figures, there is the balance sheet in draft form, which he rewrites in more formal shape.

Q. That is, he traces the items on the trial balance back to his individual working papers?

A. Yes.

Q. And makes such modifications as they disclose are necessary, and builds up a preliminary balance sheet and income statement?

A. That is right.

Q. Is that correct?

A. That's right.

Q. Now, are those statements and working papers reviewed by anyone other than this senior who is actively in charge of the audit?

A. Yes; they are all reviewed in detail by a supervisor or manager, who usually goes out to the client's office and goes over them there, where he can have ready access to any further information which he requires.

He supplements the judgment of the senior accountants by his own judgment. After going over the working papers, he may decide, for example, that there is not enough reserve for bad debts, or some accounting principle has not been properly applied. He is authorized to overrule a senior and use his own judgment, being a more competent man.

Q. Would you say that the purpose of that sort of review is to determine whether accounting principles have been followed, or whether the audit procedure has been followed, or both?

A. Both; entirely both.

Q. With any emphasis on one or the other?

A. No; I wouldn't say so.

Q. He has to see that both have been satisfactorily carried out?

A. Yes; a good workmanlike job is done, and the principles properly handled.

Q. Now, is there any other—will you outline in detail, if you can, the remaining stages of the review process that you customarily carry out, if there are any?

A. Well, you have a balance sheet that has been prepared, and then revised, and there are probably still some questions which the supervisor has not wished to take the responsibility of making a final decision on.

At that stage, he has his notes as to questionable items, or perhaps work not done—any questionable item at all.

He comes in to the partner with that, or perhaps the partner goes out to the job to see him. It does not matter which. He goes over those different questions with the partner, and the partner will deal with those, and he also will deal with any other questions which he wishes to initiate himself, with reference to the scope of the examination, the accounting principles employed, or the judgments applied.

Q. Is it customary for the partner to initiate steps of that sort, questions of that sort?

A. Yes.

Q. Or does he rely on the supervisor to bring them up to him?

A. He relies on the supervisor. He expects the supervisor to bring them up to him, but he will initiate in addition other questions.

Q. Will he review the working papers himself in any case?

A. In cases in which he is particularly interested. For example, he may want to know something about the inventory, or the bad debts reserve, or the methods of depreciation, and usually either will be produced for him, if he wants to go into it to that extent—the working papers supporting it, the tax calculations, perhaps.

Q. Would you say that the partner's principal functions are in seeing to it that generally accepted accounting principles have been followed, as distinguished from seeing whether the audit has been successfully and satisfactorily carried out?

A. I think the partner probably spends more time on the first one, but it is not necessarily the only one in his mind. I make a practice myself to question the senior accountant, or the supervisor, sometimes one or sometimes the other, sometimes both, as to what they have done in particular spot items on the balance sheet.

Q. Now, after that conference, or series of conferences, are carried out, what happens?

A. Well, any further changes that are necessary are made in the statements, and it goes in for typing. After it is typed, it is proof read, of course, and then we have a kind of a review, partly arithmetical, but just to make sure that all the additions check, that all the statements cross-check against one another—not only the figures, but

as to what is expressed in them; that you do not say one thing in one place, and another thing another place.

Q. Is there any review there to check back the statements to the original work papers, or summary schedule?

A. No; not unless some discrepancy appears.

Q. And then, of course—would you then settle that discrepancy by consulting the original papers?

A. Right.

Q. And following it through?

A. Yes.

VI. THE REPORT OR CERTIFICATE

Q. Now, who, in your firm, would be authorized to sign a certificate, or accountant's report accompanying the set of statements?

A. A partner or a manager who is specially authorized to do it.

Q. Does the same person that signs the certificate draft the form of it, or is that part of the process of preparing the preliminary statements?

A. It is usually drafted by the senior accountant, and gone over by the supervisor, and again by the partner, or the manager, in the case of a branch office.

Q. Now, in completing an examination leading to certified statements, of the type which we have been discussing, do you in general follow the form of certificate which is set forth on page 41 of this bulletin?

A. Yes.

Q. What do you understand to be the function of such a certificate?

A. To express the informed opinion of one skilled in accounts; that the accounts are fairly stated, and in accordance with accepted accounting principles, and that he has made the tests of the relative assets, income items, in accordance with accepted auditing procedures.

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

A. Yes.

Q. Is that the type of description of the scope that would be included in your audit engagement with a particular client, or would the latter be more detailed?

A. The latter might be more detailed.

Q. What would be the purpose of that? That is, why should you summarize in the certificate, but spread it—

A. That letter is a contract between you and your clients, for which, for certain remuneration, you undertake to do certain work, and I think in the contract it is better—if there is a questionable item, it is better to have the specifications, and set them down, than to have them debatable afterwards.

Q. What do you mean by questionable items?

A. Well, take, for instance, confirmation of accounts receivable. The accountant would often like to do that in cases where it is not necessary to do that. That is, he would make a more thorough check if he did it, but on the other hand, he doesn't feel it is necessary to do it to satisfy himself. There are different degrees. You can go away beyond this, or you can do just this.

Now, those are the items which I would put within the field of debatable items.

Q. Now, you say that would be included in the audit engagement?

A. Yes.

Q. But would not be set forth in the certificate necessarily?

A. That's right, we customarily put that particular point in our engagement, letters of engagement.

Q. As to whether you will or will not confirm receivables?

A. Yes.

Q. Suppose you put that in, and then it seems to you after you get in the audit, that you should perhaps confirm the receivables: What would you do?

A. We would do it, but it would not be covered by the fee we have quoted for doing certain work. We would expect to get additional remuneration.

Q. Would you do it if you didn't get any additional remuneration?

A. If we thought we should do it, and would not give a certificate without doing it.

Q. Would your opinion be any different, or would you have a different opinion as to steps in the audit procedure which this bulletin requires, as distinguished from those which are optional?

A. Yes.

Q. What would that difference be?

A. It wouldn't be necessary to state any of those. You are going to make an examination of the balance sheet and the income account. You undertake that. Now, that is, at least, a minimum, and it may go beyond the minimum, but it has to be at least the minimum.

Q. Now, if there was some procedure which was required by the bulletin, that your audit engagement did not cover; that is, there was a limitation in the engagement—should that be included as a special thing in the certificate? Would you refer to that in your certificate?

A. I can't think of any case where that would apply.

Q. I am not quite sure I understand you. Let me restate that: First, do you believe that any material omissions from the program indicated in the bulletin should be indicated in the certificate?

A. I don't know whether you should give a certificate if it is very material. I think it is up to you to determine what your audit is, and you give a certificate based on that audit.

Q. But it would not be necessary to disclose what exactly the audit consisted of?

A. I don't think so; no.

Q. Would that be true even if you had omitted a step which this bulletin requires?

A. Well, I think the auditor usually draws up his audit program. He doesn't ask the client whether to do this, or do that, or any other thing that he thinks is necessary. He goes ahead and does it.

I say, I cannot think of a case where it applies, where you have omitted anything material, and given a certificate. I have never found any difficulty in getting a client to let me do whatever I think is necessary.

Q. Will you point out for me, Mr. Broad, the language in this form of certificate, 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. It is intended to be conveyed by the words:

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

I do not think it is necessarily expressed in those words. Those words were historically the outgrowth of a compromise, to some extent, and it is to my mind an unfortunate compromise.

Q. Is it your thought, then, that you might include, perhaps, some additional language to clear that point up?

A. I think, "during the year under review" should be extended to make it—in comparison with the previous year, or the previous periods.

Q. Now, looking at this introduction to the form of accountants' report, it appears that it is intended that matter may be included in the accountants' report, or in the statements for the purpose of being merely informative, or to state limitations on the scope of his work—that is, the accountant's work—or to indicate dissent from particular practices of the company.

How is he able to distinguish, according to this particular language, as to which one of these purposes the accountant has in mind? How do you tell whether this is a dissent from the company's statement, or a qualification of the scope, or merely informative?

A. Well, if it is a dissent, I think it should be expressed as such.

Q. Where?

A. In the opinion paragraph. If it is informative, there is no need to make any qualification in that opinion paragraph. There might be an important change that the directors have decided to make, let us say, on the basis of valuing the plant and equipment. Both before and afterwards they were in accordance with accepted principles of accounting, and I think they were probably consistently maintained, but it is of sufficient importance that the auditor may think it necessary or desirable to just mention it for the information of those who read, who might not understand it otherwise.

Q. Would that information appear in the certificate, or in the body, or footnotes of the statements?

A. I think it could appear either place.

Q. Would you repeat how that would be distinguished in the certificate from a dissent on the part of the accountant?

A. Well, in the opinion paragraph, the accountant would say that his opinion was subject to qualification in respect of whatever the matter might be.

Q. And if nothing of that sort appears, then he is taking no exception to the method?

A. That is correct, sir.

Q. Now, here is a phrase that is frequently found in a good many statements, namely, that inventories have been certified as to quantity, quality, and condition, by responsible officials.

In your opinion, when you employ that phrase, are you using it in the form of a qualification of the scope of the audit, or for information, or as indicating dissent from the situation?

A. I think I would say, when we use it, we use it in our certificate, and we don't make a practice of doing that. When it appears in the financial statements themselves, I would say that the client is using it, and is giving information. The client is not going to qualify his own statement, obviously.

Q. It is merely informative?

A. Merely informative; yes.

Q. But is not a qualification?

A. That's right.

Q. Now, if in the scope of the audit sentence, that is, the second sentence of the certificate, you include language differing from that which we find here, indicating the use or nonuse of a particular test, would you say that was a qualification of your opinion in any respect, or merely informative?

I have reference particularly to the beginning of the next sentence, which starts out:

In our opinion, based upon such examination * * *.

A. An accountant's opinion must be based on an examination, or it is not worth anything. I think it would be fraud to express it.

Now, the examination, I think, must be such as is adequate to satisfy the accountant that the financial statements do say what they have purported to say.

Q. Now, if you had a further description in the scope sentence, is it your thought, then, that you would not be qualifying your opinion, but merely informing the reader as to what you have done, and, in a sense, giving him assurance that you felt it was all right to do it that way?

A. Well, let us take the example mentioned here, where part of the work has been performed by other accountants. The accountant would have no reason to doubt, as distinct from definite reason to believe, in a case like that. Perhaps I am understating it, because he has got the authority of some other responsible or reputable accountant for the figures which he has incorporated, but they are not figures which he himself has audited. They are figures which somebody else has audited, and he wishes the public to accept them as such.

Q. (By Mr. WERTZ.) If you include language to that effect in the scope paragraph, are you saying that you have seen nothing in the course of your examination review of that work which would lead you to believe that it is otherwise than as presented?

A. Yes.

VII. GENERAL SUGGESTIONS AND COMMENT

Q. The suggestion has been made that corporations should rotate auditors at frequent intervals. I believe you expressed an opinion as to that in your opening statement, did you not, Mr. Broad?

A. Yes; I covered that.

Q. Now, what do you think of the desirability of auditors appearing at, shall we say, directors' meetings and also at stockholders' meetings?

A. I think I covered that, too.

Q. Did you cover both of those? I am sorry, I thought you had left out the stockholders' meetings.

A. No; I covered that.

Q. Would you think it would be desirable for the auditor to be charged with seeing that directors receive copies of the certified reports in advance of the directors' meetings?

A. The auditors should be charged with their responsibility?

Q. Yes.

A. No.

Q. Do you think it would be desirable if directors did get them in advance of the meeting?

A. I think it would be desirable for those directors who take an interest in the financial statements to receive them.

Q. Do you think it might make some of the directors more interested if they got these reports sufficiently in advance so they would have time to study them if they cared to?

A. Yes; I do.

Q. I have in mind here, of course, not merely the published financial statements but your detailed reports to the corporation on which is based—

A. I misunderstood you on that.

Q. What is your thought as to that?

A. I would like to see the reports go to the directors and particularly comments which accountants make from time to time on possible weaknesses within the organization; routine matters, internal check and control, and so forth.

Q. Do you think it might be feasible to have the auditors mail such reports directly to the directors at some stipulated time in advance of the meeting?

A. I think it would be preferable rather than that to have a committee of the directors which is charged with the responsibility for matters relating to the accounts and the audit rather than to bother all the directors with it. Everybody's job is nobody's job.

Q. Have you any opinion, or can you express an opinion, as to how often the directors in present-day practice get these reports? That is, what do you do now; do you just send them over to the company?

A. Yes. Usually four or five copies.

Q. Do you know whether those are sent along to the directors?

A. In most cases, I think not.

Q. Do you think it would be desirable for auditors to be—to express in their report to the corporation any significant developments or changes during the period audited?

A. Can I answer the last question first?

Q. Surely.

A. When I say directors, I mean directors excluding the officers. When I say the directors do not receive copies of the detailed reports, I am not referring to the officers who are also directors.

Q. You think the officer-directors would get them?

A. Yes.

The EXAMINER. You distinguish the nonmanagement directors from the management directors, so to speak?

The WITNESS. Yes, sir.

Q. (By Mr. WERTZ.) Do you have that other question in mind?

A. I think it would be quite helpful to those who are interested in analyzing financial statements if balance sheets were given in comparative forms, at least, condensed balance sheets, not perhaps the detailed balance sheets. I would say the same to the profit and loss account.

In addition to that, I think a statement of application of funds would add to the understanding of what has happened within the corporation during the year.

What I mean by a statement of application, how much has been expended on plant, what has happened to the profits that have been made during the year, how much has gone out in dividends and has the depreciation reserve been put back into the property and things of that kind.

Q. Do you make such analyses in the course of preparing your own statements? I mean, preparing statements for the client?

A. We put such an analysis in our detailed reports where we deliver detailed reports.

Q. Do you prepare any such analyses in connection with your own work on the statements? For example, a statement of application of funds.

A. Not formally as such.

Q. That is, it is not a required step in your audit procedure?

A. No. All our working papers, or most of our working papers, start off with a figure from the beginning of the year and at the end of the year, and the changes there would be indicated in our working paper, but we don't make a practice of gathering them altogether.

Q. Do you attempt to urge upon your clients the adoption of the natural business year where that seems desirable.

A. Yes, with limited success; very limited.

Q. How would the adoption of such a principal assist you in your work?

A. May I read a little memorandum on that?

Q. Certainly.

A. In most accounting organizations an unduly large proportion of the work falls in the short period from, say, January 1 to March 31; probably more than half the number of engagements handled in a year reach their culmination within this period. This has resulted in a situation which no one deplors more than the auditor; namely, an excessive physical burden on all members of the accounting organization as well as the necessity for supplementing staffs by the addition of temporary assistants.

Under such continuous forced pressure, one would be a hardy soul who could conscientiously assert that the accountant has as much time for reflection, or to give all his clients the same amount of time, service, and attention, as he could if the work were spread more evenly throughout the year so that a full-time permanent staff could be occupied more or less continuously throughout the 12-month period.

Much could be done to alleviate the situation referred to through the adoption of a natural business year. There is no particular virtue in having a company's fiscal year end at the close of the calendar year; on the contrary, in many lines of business some other date would have distinct advantages to corporations and their officials in that the accounts could be closed at the end of a season of activity and before the commencement of the next season.

At such a time inventories, accounts receivable, and accounts payable are normally lower and the company is usually in its most liquid position, so that statements based on a relatively larger proportion of completed transactions could be prepared in which the elements of judgment and estimate would be minimized.

Furthermore, the officials and their staff in a season when activities are reduced, could give more attention to closing transactions with

less interruption to their normal daily duties. This idea of "the natural business year" has been supported by accountants quite strongly, but, as they would themselves also benefit from the change through relief in the present congested period, support from influential disinterested bodies or from industry itself would be much more effective.

Q. Coming back to some of the general questions as to present practice in auditing. 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. Well, in a large organization with many subsidiaries, a lot of intercompany transactions, intercompany holding of securities, minority interests and so forth, they are requiring a great deal of skill in the process of consolidation. A large part of the time of the top man is probably spent in accounting as distinct from auditing.

In that case there would probably be other senior accountants doing some of the auditing, the part that a senior should do. From that stage, as I said this morning, to get down to a minor stage where the senior accountant does the whole job now in between there, you will have different degrees.

Q. Well, in the case of a large company, would you say that the emphasis is particularly on seeing that accounting principles have been followed—accepted accounting principles as compared to establishing—verifying the assets and liabilities?

A. No, I wouldn't say that. I would say that there would be, relatively, the determination of the valuation of the inventory was a very important item in a large company, a large manufacturing company, and that the determination of the adequacy of the reserve for bad debts is quite important.

Those are matters of auditing, I think, rather than accounting.

Q. Now, would you indicate briefly the items in the balance sheet and income statement which your own auditing practice and procedure verifies to your satisfaction by tests independent of the accounting records of the company and information furnished by its officers and employees? Just run through them.

A. Of course, starting at the end of the balance sheet, which is the easiest end, the capital stock is confirmed usually by a certificate from the trust company that is charged with that responsibility and which issues the certificate.

The same refers to funded debt and accrued interest on funded debt or sinking fund balances.

On insurance, you see the insurance policies, investments, you see the securities, which are, of course, the investments; you come to the working capital and I like to regard that as kind of a flow.

Take a simple case, for example. The companies start off with a certain amount of cash. It buys inventory with that. It sells the inventory and creates accounts receivable. The accounts receivable are paid and the money comes back in cash and the cash has gone around in a circle.

Now, the accountants cannot confirm those transactions at any particular point round the circle he wishes to choose, he couldn't confirm them all. He can confirm them all when they come back to the cash account.

If a company starts off with, say, \$100,000 worth of working capital, that flow may continue ten times during the course of a year so that perhaps there may be a million dollars' worth of sales during the year. If in those million dollars in sales, \$900,000 passes through the cash accounts, it is pretty good proof. I think it is more than circumstantial, it is to some extent direct proof that those transactions were real ones because you can't get the cash from the customer unless you sold him the goods. You can't sell him the goods unless you bought them and had them on your inventory.

Now, at the end of the year you confirm directly only the cash that is in the bank. You may make some check of the receivables by direct confirmation, but that is done less frequently than it is left undone.

I think that by checking the turnover nine times in the year as compared with the one time at the end, you have made a very substantial direct confirmation of the transactions and of what is left.

Q. Your thought there depends in large part, does it not, upon establishing the existence of the cash at the end of the year?

A. Yes; and the transactions through the cash account within the year.

Q. So that it would be necessary to take every precaution to satisfy yourself on that point in order to follow the logic you have just mentioned?

A. Yes.

Mr. WERTZ. Off the record.

(Discussion off the record.)

The WITNESS. On fixed assets in a small corporation, the auditor often sees the plant, he hasn't any idea as to perhaps its being worth actually what it is carried at, but just a general idea.

A large corporation over a period of years is quite frequently, perhaps more frequently than not, appraised, which is available to the auditors. It might just be an insurance appraisal, but some one has seen the plant and he knows it.

Q. You mean some one independent of the company?

A. Yes; that's what I mean.

Q. Turning back to the certificate for a moment. The second paragraph, I believe, reads as follows:

In our opinion, based upon such examination, the accompanying balance sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting, consistently maintained during the year under review the position of the company at December 31, 19—

Whatever the date is—

and the results of its operations for the year.

Now, when you use this form of certificate, do you mean that in your opinion, as a public accountant, the examination made has been sufficient to establish to your own satisfaction the existence of the assets and liabilities and the authenticity of the transactions and operations?

A. Yes, sir.

Q. Have you any further comments or suggestions you would like to offer, Mr. Broad?

A. I did prepare a memorandum. Most of it has already got in the record in some other forms, but there are one or two points left over which at this time I would like to read.

Q. I wish you would.

A. A lot has been said about the importance of an effective system of internal check and control within the organization and this applies more particularly to the operating accounts as distinct from the balance sheet.

It is usually not essential in any large organization and it is obviously impossible within the bounds of a reasonable fee for the auditor to check more than a small proportion of the actual transactions consummated during the period under examination.

For this reason, the effectiveness of the system of internal check and control is receiving an increasing attention from auditors. Such control naturally centers in the comptroller or similar official within the organization; and anything which increases the power, the prestige and the independence of this officer would tend to make his function within the organization more valuable.

Every large business enterprise naturally divides itself into such functions as sales, purchasing, manufacturing, and accounting. There is usually one officer responsible for each of these departments, and the officer in charge of the accounting department, often called the comptroller, usually has little or no part in the actual operation of the business. His duties are primarily to keep the accounts and to report upon the operation of the other departments through financial statements and other media, to maintain effective internal check and control, as well as to see that the assets of the corporation are properly safeguarded.

The comptroller has at times been looked upon as a junior official of the corporation, and sometimes he is not even an officer. His position, his prestige, and his value would, I believe, be increased were he elected as an officer by the board of directors, at least in the larger organizations instead, as is frequently now the case, of receiving his appointment from an officer; it might sometimes be preferable if he were even a director.

One other point: I have previously referred to the natural business year as a factor in improving auditing conditions and efficiency. Another important step in the direction of greater regularity of employment, and consequently more efficient handling of work, could be taken if more of the auditor's work could be done before the end of the fiscal year.

All of the examinations, even of the balance sheet, need not necessarily be made at the year-end; for example, a review of the methods of internal check and control or of the methods of controlling and checking inventories could be done just as effectively throughout the year.

Again, if accounts receivable are to be confirmed, either in part or in whole, there is no particular necessity for doing this at the balance sheet date, in fact, there are advantages in choosing other and different dates from year to year.

But, to afford the auditor an opportunity to do this work, it would be necessary that he be appointed early in the year, as I have previously suggested, instead of, as is frequently the case now, towards the end of the fiscal year or after its close.

That's all I have in mind.

Mr. WERNITZ. Have you any questions?

Hr. HENDERSON. No questions.

Q. (By the EXAMINER.) Mr. Broad, there is one question that I was interested in, and that was the preliminary training and qualifications of employees when they first come to you. Take juniors, for example. What prep school or other preparation do you require of them?

A. In New York, for a permanent staff, we require a man who has got a university degree and preferably an accounting school course. Sometimes both, sometimes one or the other.

There are exceptions to that rule, particularly bright high school graduates of whom we have some knowledge and for some reason we think are going to be suitable.

Q. Do you require any business training, preliminary apprenticeship in business institutions?

A. Not necessarily. We take a junior accountant on our permanent staff for the long pull and not for what he is when he comes to us. We look to him in the future more than the present; we expect him to develop.

Q. Where did you expect him to get training in matters of customs, respecting traffic conditions, bills of lading, drafts, banking, and things of that kind that he might or might not get in his schooling?

A. Well, if he has an accounting course, usually that includes some business law, particularly if he had a post-graduate course he has usually got a theoretical knowledge of those matters. He would get his practical knowledge on actual engagements with some prompting. As I said before, a man who has no experience is a raw junior and he gets more attention from the senior.

Q. This morning you mentioned the investigation of documents in connection with the receipt of goods. To what extent would you carry that investigation of documents, beyond the receiving slip, or would you carry it into the bills and other things?

A. The primary receiving documents, a receiving slip made out by the corporation itself. It is usually made out from a copy of the purchase order when it is first entered. As a rule, you would not go behind that unless you had reason to doubt it.

Q. Do you think it is a good practice to have the purchase order in the receiving department so that the receiving clerk makes it up from a receiving order or do you think it should be made up independent?

A. Theoretically, the latter is preferable.

Q. Now, with respect to inventory, do you make it a custom in your office to investigate and report on subjects dealing with the future, hedges and such transactions as they might affect inventories?

A. Yes; we give considerable attention to that in businesses dealing with commodities where there are futures.

Q. Do you think that is good practice to do that?

A. I think it is essential.

Q. Now, where you are dealing with goods that are in warehouses, to what extent do you investigate the community of ownership of the warehouse company and the client or any other interest that might be the same?

A. I think when you do that you are getting out of the role of the auditor into the role of a sleuth. As a rule, I would say we don't do it unless we have reasons to suspect something. You are referring to hidden interests?

Q. Yes; hidden interests. Do you think that the accountant ought to include in his certificate a reservation where he has made an agreement with the client not to circularize accounts receivable, or accounts payable or make test checks on inventory?

A. I think it is the accountant's responsibility to decide whether these checks or confirmations should be made or should not be made. If he feels they should be made, I don't think that he would be justified in omitting the procedure regardless of any qualifications in the certificate.

Q. Putting yourself in the position of the stockholder who reads that certificate and reads that report, what do you feel is his feeling of the extent and scope of that certificate with respect to the audit or examination which has been made?

A. I would like to send every stockholder a copy of this thing and get him to read it, but I don't think that is practical. I think that there is a lot of loose thinking and a lot of lack of thinking on the part of everybody, some informed people, as to what a certificate purports to say and does say. I think it is more a lack of thinking than loose thinking. If they thought at all, some people, they would realize that what they think is unreasonable.

Q. Well, now, Mr. Wertz asked you one question about the responsibility of the senior on your audit and whether or not you rotate.

Have you considered the question of some dual responsibility to avoid rotation?

A. We have tried dividing up the responsibility on engagements in isolated cases but we found that it doesn't work well. One man has got to be responsible if you are going to have a good job well done. I think if there was any division of that responsibility, you would suffer more than you gain.

The EXAMINER. Anything further?

Q. (By Mr. WERTZ.) Mr. Broad, something you said there raised just one or two further questions. If the receiving ticket is actually made out from the purchase order, in what way is that evidence that the goods have actually been received?

A. Well, the document intended as a receiving ticket eventually may perhaps be one of many copies of the original purchase order. It is perhaps filed with the shipping department and is kept on file there until the goods are received, at which time, when the goods come in, the shipping clerk will look on his file to see what is expected and will pull it out and indicate on it that goods are received, after giving it the necessary references, dates, and signatures.

Q. Is it customary, do you know, to leave out the quantities in connection with the copy of the purchase order that goes to the receiving department?

A. I don't think that is customary.

Q. That would assist, perhaps, in ascertaining that the goods had actually been received, would it not?

A. I don't think that you are relying upon—as a rule upon one person in the quantity of goods received. One man takes them in but they may leave him and go to some stockroom where they are checked again. As a rule, there is more than one check. I think you would bring about more errors by leaving the quantities out, more difficulties than you would gain by the additional check.

Q. Would you expect a receiving clerk to indicate the condition of the goods in which they were received, that is, whether they were damaged or not, according to the shipping instructions?

A. Condition?

Q. The condition of the goods when he received them. That is, whether the packages were broken or something of that kind?

A. I think that would probably call for a special report or perhaps refusal to accept the goods.

Q. So that, he would compare with the goods received, not only the quantity but so far as he could as to quality and condition?

A. As to apparent condition.

Q. That is what I mean.

A. Yes.

Q. One other question. In your discussion with the examiner as to goods in warehouses, you mentioned the fact that you would not search out for hidden interests. How about—do you make any study to determine who the warehouse is controlled by, what its affiliations are and so forth? That is, to find out whether it is really an independent warehouse or not?

A. It is not very usual to find a great amount of goods in some outside warehouse. It is usually a warehouse rented or owned by the corporation itself. I can't think of any general practice on that particular score because I don't think I have ever run across it where it is important.

Q. (By Examiner HUMPHREYS.) If you ran across a case where a very substantial amount of the inventory was either held by vendors or in warehouses, would you make a search of correspondence files or other collateral sources of information to verify the genuineness of it?

A. What I would do, now, perhaps, would be to a large extent by hindsight. I don't know what I would have done, and I don't think I ever ran across a case in the past. It would make a difference whether the goods were paid for or not. It would make a difference if it was the company's own warehouse and their own employees. I would think if you had an outside concern, it would be protected more than it would be if it was in your own warehouse.

Q. Would your men search out the correspondence files in such a case to find some collateral evidence beyond the purchase order and the invoice?

A. Well, you would see reports of shipments going through and also reports of goods on hand. These would presumably be periodical reports which would be filed and you would see those and consider those as evidence of the proper operation of that warehouse. I don't think, unless you had cause for a doubt, you would, as you put it before, adopt the role of sleuth on it.

Mr. WERNTZ. You indicated you would expect the receiving clerk only to examine the apparent condition of the goods. Do you know whether it is customary to have any person in the organization examine the goods to determine whether they are, in fact, in good condition and of the quality ordered and do you know whom that would be ordinarily?

The WITNESS. It would, of course, depend to a large extent upon the organization. If it was a stock clerk, had the goods reached him, he would sort them out and put them in their proper place in the

warehouse and at that time go into considerably more detail than the almost-laborer who takes them in at the door. Now, along the chain there the whole process is properly the process of receiving the goods.

Mr. WERTZ. And you would expect someone to be charged with the duty of ascertaining whether they had, in fact, the goods ordered, as to quality, condition, and so forth?

The WITNESS. Oh, yes.

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

The EXAMINER. You are excused.

(Witness excused.)

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

(Whereupon the hearing was adjourned until 10 o'clock a. m., February 21, 1939.)