

BEFORE THE SECURITIES AND EXCHANGE
COMMISSION

In the Matter of MCKESSON & ROBBINS, INC.

OFFICES OF THE SECURITIES AND EXCHANGE COMMISSION,
120 Broadway, New York, N. Y., Thursday, February 23, 1939.

Met, pursuant to adjournment, at 10 o'clock a. m.

PROCEEDINGS

The EXAMINER. Will you be sworn, Mr. Stempf?
Whereupon:

VICTOR H. STEMPF

called as a witness for and on behalf of the Commission, being first duly sworn, was examined and testified as follows:

The EXAMINER. Will you give your name and address to the reporter, Mr. Stempf?

The WITNESS. Victor H. Stempf, 80 Maiden Lane, New York.

The EXAMINER. Mr. Stempf, it is customary at the Commission's hearings to apprise witnesses of their constitutional privileges. You have the privilege of refusing to answer any question if you believe such answer will tend to degrade you or subject you to fine, imprisonment, or forfeiture. That privilege extends to each and every question that may be propounded to you.

I. AFFILIATIONS AND BACKGROUND

Q. (By Mr. WERNITZ.) What is your present firm affiliation, Mr. Stempf, and how long have you been a partner?

A. I am a partner of Touche, Niven & Co., since 1922.

Q. For how many years have you been engaged in accounting work?

A. I have been engaged in the practice of public accountancy since July 1915, starting as a junior with my present firm, serving as an assistant, senior, supervisor, branch manager, and partner in St. Louis and New York.

Q. Had you been in any type of accounting prior to that?

A. I had some temporary work in private industry before that, particularly in the department of the auditor of disbursements of the Southwestern Bell Telephone. That was during my college days.

Q. Did you have any educational training prior to going into accounting work?

A. I received the degree of Bachelor of Commercial Science from the School of Commerce of St. Louis University in St. Louis, Mo., in June 1915.

Q. Are you a certified public accountant?

A. I am a certified public accountant by examination in Missouri, 1917, and hold like degrees in New York, Connecticut, Ohio, Minnesota, Michigan, and California, by reciprocity.

Q. Could you indicate generally the size and type of your firm—type of business you do?

A. My firm has its principal office in the City of New York with branches at Chicago, St. Louis, Minneapolis, Los Angeles, Detroit, Cleveland, and Hartford. There are 17 partners with a permanent accounting staff which has in recent years averaged approximately 150 and which has reached a peak of about 230 during the busy season. My firm has an interest in the firm of like name which operates in Paris, France, and is closely associated with the firm of George A. Touche and Co. of London and the firm of George A. Touche and Co. of Canada. You asked also about the principal types of clientele, I believe.

Q. If you will.

A. Our clientele includes a representative group of companies listed on the New York Stock Exchange and other exchanges throughout the country, and a great number of companies not so listed. These clients comprise a fair cross-section of American industry and commerce. A number of heavy goods manufacturers, manufacturers of consumption goods of many classes, such as food stuffs, textiles, light equipment, et cetera, motion picture producers, transportation companies, investment companies, financial and factoring organizations, department stores and other retail establishments, several of the large real estate operating and holding companies, personal estates and trusts.

Q. Are you a member of any of the professional accounting societies?

A. I am vice president and acting chairman of the New York State Society of Certified Public Accountants, national vice president of the National Association of Cost Accountants, chairman of the Committee of Federal Taxation of the American Institute of Accountants, and a member of the American Accounting Association. I am also a member of the State societies of certified public accountants in most of the States in which I hold the certified public accountant degree.

Q. Have you been active in professional activities of the societies otherwise than through these offices?

A. I am at present a member of the committee on practice procedure of the American Institute of Accountants, and of the special committee on auditing of the same organization. I have served in similar capacities in the New York State Society of Certified Public Accountants and likewise in the National Association of Cost Accountants.

Q. Have you published any papers or other publications on accounting topics, Mr. Stempf?

A. I have written a number of articles on general and cost accounting subjects which have appeared in the Journal of Accountancy, in the bulletins of the National Association of Cost Accountants, in the quarterly of the American Accounting Association and in the bulletins of the American Management Association.

Q. Have you been active in other types of accounting work such as educational work, addresses, and so forth?

A. I have appeared on the programs of the conventions of the American Institute of Accountants, the American Accounting Association, the National Association of Cost Accountants, the American Management Association, the National Tax Association, the National Retail Drygoods Association, the Comptrollers' Institute, various State societies of certified public accountants, and the accounting forums of several of the larger universities. I have also appeared on several occasions before the United States Senate Finance Committee on matters of Federal income taxation in relation to accounting and financial implications of proposed legislation.

I taught the senior accounting and auditing courses at the St. Louis University for several years around 1920, including lectures on cost accounting.

II. SCOPE OF EXAMINATION OF FINANCIAL STATEMENTS

Q. Now, Mr. Stempf, would you indicate and distinguish the various types of accounting services rendered by public accountants which result in or lead up to the certification of financial statements using your own firm as an example?

A. Yes. Basically there are three: Audits, examination of financial statements, and investigations. The term "audits" is used generically to indicate all types of examinations. In its more limited meaning it generally contemplates a detailed examination of the accounts, records, and underlying documents of business as distinguished from limited examinations.

Q. Would you say that was equivalent to what is sometimes called the detailed audit?

A. Right. Examinations of financial statements contemplate limited examinations depending largely upon sampling and testing of accounts, records, and underlying documents of a business to an extent necessary to satisfy the independent public accountant that the representations of management as expressed in financial statements are fairly stated. Investigations are usually made for special purposes. They may be decidedly limited, such as the examination of the accounts or records maintained by a particular employee or relating to a particular department.

These would rarely result in the certification of financial statements, but would entail limited reports. In other cases these investigations may relate to the proposed acquisition of a business involving the examination of affairs relating to a period of years and in certain predetermined directions, a more detailed examination than would be undertaken ordinarily.

Q. Which type of such services do you customarily render in preparing annual reports to stockholders for credit purposes and the like?

A. My firm undertakes the type of service which I have referred to as examinations of financial statements in engagements coming within the purview of the Securities and Exchange Acts or for purposes of reports to stockholders or credit matters. In connection with the 1933 Act, this may involve some additional investigation of

prior years' operations or further detailed examination to fit the requirements of the information needed for the registration statements to be filed thereunder.

Q. Now, are you familiar with Commissions' exhibit 117, which is the bulletin "Examination of Financial Statements by Independent Public Accountants" published and prepared by the American Institute of Accountants?

A. I am.

Q. Did you, or your firm, partners in your firm, participate in its preparation?

A. Neither I nor any of my partners had any direct connection with the preparation of the Institute bulletin entitled "Examination of Financial Statements," although we probably did respond to any questionnaire or general correspondence which may have been issued by the Institute or its committee at the time. I have no personal recollection of such participation.

Q. What, in your opinion, was the purpose of preparing and publishing such a bulletin?

A. The purpose of such a bulletin, I have always thought was to serve as a general guide and reminder of representative measures, a combination or selection of which may be used in the conduct of an examination depending upon the character of the organization examined, rather than a set of specifications to be observed literally.

Q. You have described the types of services which your firm customarily renders. Where would you classify the examination contemplated by this bulletin in those services?

A. The bulletin outlines broadly what we have come to call an examination of financial statements, largely a matter of habit resulting from the general acceptance of the bulletin as a general guide.

Q. Would you say that in such examinations the principles of the bulletin are of general application to all types and sizes of companies?

A. Yes. Insofar as the provisions of the bulletin may be applicable to a specific business.

Q. Do you follow this bulletin in general in your own practice?

A. Yes.

Q. Do you require the members of your staff to be familiar with it?

A. Broadly speaking, yes; in that our own audit programs adopt or adapt the provisions of the bulletin to the specific case.

Q. Speaking generally, would you say that the steps contemplated by the bulletin are minimum or maximum?

A. Speaking generally, the provisions of the bulletin are viewed as a minimum to be embodied in our own programs to the degree applicable to the specific case.

Q. Well, would you say that if you struck out of the bulletin those steps which were inapplicable, because the conditions were not present, that the remaining procedure of the bulletin was a minimum or maximum?

A. Correct; a minimum.

Q. Now, how would you compare the examination contemplated by the bulletin with that generally followed by your firm in this type of examination?

A. Generally speaking, the scope of our examination is at least as broad as that outlined in the bulletin in respect to material items.

Q. Would you say that historically speaking this bulletin led to changes in your own practice or in audit practice in general?

A. Accounting and auditing practices and procedures have been in a continual transition through the years seeking to keep abreast of changes in growing needs of business for more effective and more expeditious methods commensurate with the development and adoption of methods of internal control and internal audit. The promulgation of the bulletin gave recognition to some changes in practice which we had affected previously and similarly led us to adopt other changes which had gained substantial recognition by the accounting profession.

III. OFFICE METHODS AND STAFF ORGANIZATION AND TRAINING

Q. Now, Mr. Stempf, in the questions which are coming, I would like to have you distinguish, if necessary, between practices as they were before the proceedings in the McKesson & Robbins case and practices since then, if there is any difference, if you made a change in your practice, just point it out as you see fit to answer these particular questions.

When a client comes for the first engagement, is it customary for you to make any investigation of the reputation or credit rating either at the outset or during the course of the audit?

A. The great majority of our new clients come to us through existing clients or through investment bankers or others known to us. In such cases we rarely make any independent investigation of the reputation or credit rating of prospective clients.

In cases where a new client comes to us without introduction from reputable people known to us, we make some inquiry to satisfy ourselves as to his past activities and connections and on rare occasions resort to reports from investigation agencies.

Q. Where would you obtain those reports?

A. I don't recall the names but there are several such organizations in existence in New York City.

Q. Now, from your experience in conducting examinations of the type you have described, who would you say exercises the prerogative of appointing auditors for that purpose?

A. From my own experience, I believe that management generally appoints the independent public accountants. More usually with the informal consent of the board of directors than by resolution of the board and rarely by stockholder action.

Our primary responsibility runs to those who employ us. In this respect we recognize management as the agent of the board of directors, the latter occupying a fiduciary relationship toward the stockholders and accordingly we address our reports to the board of directors.

We recognize also a responsibility to others who may rely upon the financial statements. In this connection I would like to stress what I consider the foundation of the relationship of the public accountant to the statements which he certifies. Such financial statements are primarily the representations of management and it is the functional responsibility of the independent public accountant to undertake such work as he may consider pertinent and effective within the limits of a

reasonable economy to satisfy himself that the representations of management are fairly stated.

Q. When you say management, to whom do you refer there?

A. I am speaking of the officers of the corporation.

Q. That is the appointed and elected officers?

A. Right.

Q. When you undertake an engagement of this character what representative of your firm determines the scope of the audit and do you re-examine that scope of audit annually or is it fixed?

A. In the final analysis the scope of the examination is determined by a partner. The scope of the examination is reviewed annually in the case of continuing engagements.

Q. You say in the final analysis the partner determines it. Do you mean that some other person may make a preliminary study and makes recommendations which the partner will pass upon?

A. That is correct, a senior or a supervisor will make a preliminary survey and propose a program.

Q. When you say that it is reexamined annually do you mean that you have a procedure by which you automatically look into the question as to whether the scope of the audit should be changed or do you mean that if anything comes to your attention that you would alter it?

A. Whether or not anything particular comes to our attention it is a matter of established procedure that the supervisor will review the previous year's program in connection with the working papers relating to that year and discuss with the partner suggested revisions in the approach or in the extent of the detailed examination undertaken.

Q. When questions as to the scope of the audit arise, who expresses an opinion or makes the determination for the client?

A. I have discussed such matters with presidents, vice presidents, secretaries, treasurers, and chief accountants. It depends entirely upon the respective organization as to the delegation of authority. In an organization with a thoroughly competent comptroller, it is not unusual to discuss such matters with that official and only in the event of disagreement to carry the discussion beyond him to the president or even to the directors. Generally, no such questions arise because we are given carte blanche.

Q. You have listed quite a variety of officers. Do you mean that it would depend upon the particular company as to whom you should discuss these matters with?

A. That is correct.

Q. Now, looking to the future, Mr. Stempf, would you have any thought as to whether there should be a change in the method of selecting auditors or a change in the method of determining the scope of the audit?

A. In my opinion the selection of the auditors should rest upon a recommendation by the board of directors approved by the stockholders. Such procedure would prevent preemptory dismissal of accountants by management and a substitution of others without the disclosure of reasons.

It would lead to a closer relationship between directors and accountants and better understanding of the character and scope of auditing service.

Preferably, I believe this relationship should be established as the result of corporate action providing for the appointment of auditors at the beginning of the year with right of access to records throughout the year and requiring the presence of the auditor at board meetings and meetings of stockholders at which the reports of the auditors are to be discussed; the auditor being afforded an opportunity to report orally and being required to respond to questions.

Q. What advantages do you have in mind when you speak of the benefit of not having peremptory dismissal?

A. Those occasions are rare, but all of us in practice have either had personal experience or have a knowledge of cases where disagreement has arisen between the accountant and management and where management has said, "Well, we can probably get other accountants with other views," with the result that prior accountants may be dismissed and new accountants brought in, and usually in such cases, perhaps, the board and certainly the stockholders do not learn the reasons for the change.

Q. Now, looking to your own firm, Mr. Stempf, do you classify your personnel in any particular way?

A. Our staff is classified as managers, supervisors, seniors, assistants, and juniors. This classification is flexible, depending upon the complexity of the engagement. By that I mean that in relatively simple situations we might use an assistant in the capacity of a senior under constant review. In other cases a supervisor or several of them may act as seniors on a large engagement under the direction of some other supervisor.

Q. When you accept an audit engagement, how do you determine the personnel who will work on that particular engagement?

A. Engagements are confirmed by the partner who has conducted the negotiations, who then consults with our partner who serves as personnel director in the selection of staff to man the engagement.

It is our general policy to have every supervisor work with several partners. A supervisor having been selected he determines the requirements of the engagement by consultation with the partner in charge and then agrees upon the assignment of men as the result of consultation with the personnel director. This relates to large engagements.

By agreement among partners, the direction of a specific engagement may be shifted from one to another. Two or more partners may in some cases jointly direct a large engagement. In smaller assignments, the partner may directly supervise an engagement entrusted to the direction of a senior.

In all cases the procedure seeks to maintain a policy of double check, the man who conducts the examination being supervised during the course of the work and reviewed when the work is completed by another of greater experience and responsibility, a partner in any event exercising at all times general supervision and review and assuming ultimate responsibility for the report.

Q. When you say double check, Mr. Stempf, do you mean there that if a man prepares certain work himself that is always gone over in detail by some other person?

A. In more or less detail; yes.

Q. So that the work done by juniors is reviewed in detail by the senior, and any individual work done by the seniors is then reviewed by the supervisor, et cetera, and so on up the line?

A. That is correct.

Q. Are these assignments permanent on successive audits or do they change from time to time in your firm?

A. Generally speaking, the assignments of partners and supervisors are permanent arrangements for successive audits but we maintain a definite policy of alternating seniors, assistants, and juniors to the end that such employees shall not repeat an assignment more than 2 or 3 years in succession. This does not, of course, involve a complete change of staff in any 1 year.

Q. Do you find any disadvantages in that policy?

A. All of the advantages of continuity are essentially inherent in this arrangement, in my opinion. The change of staff injects new blood and new viewpoints, mitigates staleness, and the inclination to take matters for granted, and these advantages far outweigh any theoretical disadvantage which might be advanced. From a professional standpoint which seeks to serve the ultimate best interests of clients also, the diversification of experience of assistants develops better men, capable of assuming greater responsibility in many lines of business.

Q. Now, how do you go about recruiting juniors for your permanent staff, also for your temporary staff?

A. Juniors for the permanent staff are recruited largely from the temporary staff, the latter being obtained from colleges and schools and through employment agencies.

Q. Is there any particular policy followed in retaining temporary men in a permanent role, or is it a question of competition there?

A. Men with college training are preferred, although we do engage men with high school training for the temporary staff. Selections are made for the permanent staff on a competitive basis and other qualifications being equal those with college training would be chosen.

Q. What do you have in mind when you say a competitive basis there? Is that just competition in the work they have done subject to your own judgment or do you have an examination of some sort?

A. We have a continuous system of reporting of men in charge of engagements to our personnel director relating to men who are working under them dealing with questions of intelligence, adaptability, all of the characteristics that are comprehended in judging a man's capability.

Q. Would you say that on the basis of those reports and any personal contacts the man in charge of promotion has with these men would determine their promotion?

A. Very largely, yes; although those reports relating to any one individual come from a number of seniors and supervisors during the course of a year.

Q. Now, let us take these men whom you have put on your permanent staff as juniors; do you have any other course of further education or self education which they are required to follow? Do you require them to get a C. P. A. certificate before they become eligible for advancement? How do you work that?

A. We subject new employees to a written and oral examination, but we do not conduct any training school as such for our juniors, as we are of the opinion that courses conducted by the universities and colleges are more effective.

We do require that our juniors pursue their accounting education and we do require the C. P. A. degree for retention on the staff and for ultimate advancement. The great majority of our semi-seniors have attained the C. P. A. degree. There are only exceptional cases of seniors who do not possess the degree, and no man holds the position of supervisor who does not possess the degree.

Q. Or partner.

A. Right.

Q. Now, will you describe briefly the type of duties which you customarily assign to juniors, and do you make any distinction between temporary juniors and those on your permanent staff there?

A. Juniors undertake only the most elementary duties of transcription, footing, and extending records and schedules, vouching simple routine expenditures, and such other details consistent with their progress on the staff as may be performed satisfactorily under the constant direction of a more experienced man.

Q. Would you say that their duties required a knowledge of accounting, or are they purely mechanical?

A. Definitely they do require some knowledge of accounting in order that they may appreciate what they are doing and what the significance of the work is.

Q. Turning to the seniors for a moment, from what sources do you ordinarily obtain them, and what things do you look for in the men you are going to promote?

A. With rare exceptions our seniors have been developed within our own organization and have come up through the ranks as a result of competitive rating, which I have referred to in my previous answers.

Q. Could you distinguish the type of duties that you assign to seniors from those assigned to juniors. Describe them roughly.

A. I think the basic difference is one of judgment and experience, that there is less degree of judgment needed in the simple vouching operations handled by juniors, whereas a senior is a man who not alone knows how to solve a problem, but who can recognize a problem when he sees one.

Q. Do you consider it a part of the senior's duties to train the men who are under him, that is, the juniors?

A. Yes, we do, by the supervision of the work which the junior performs and by the review and discussion of the junior's work upon completion of his particular assignment.

Q. With reference to the supervision of the work that he does, just what do you have in mind there? That is, does he actually examine some of the original documents to see if the junior has done what he has been instructed to do?

A. No; that would be done by the assistant under whom the junior is working. The same thing relates to the assistant who is supposed to discuss in a critical review what the junior does.

Q. Is that process of criticism and review the system upon which you rely to know that the junior is doing a satisfactory job?

A. That is correct.

Q. As to the partners in your firm, do they participate in carrying out the field work of the audit program, do they visit the client during the period, or do they visit him at other times during the year? What is done there?

A. The partners of the firm do participate in the execution of engagements by review in more or less detail of the working papers, by discussion of the problems of the examination with the supervisor or senior, by personal contact with the client during the course of the examination, and at other times during the year.

Any of the officers of the client may be consulted, concerning matters which relate to the particular functional responsibilities of the individual. In the majority of cases, such questions are discussed with the officers charged with the responsibility of directing matters relating to finances and accounting or employees in charge of those functions.

Q. In your own personal experience, Mr. Stempf, when you go out to a client, do you simply interview the officers on particular matters, or do you, shall we say, circulate around a little bit?

A. I make it a practice to maintain a contact with my clients throughout the year, to discuss the general progress of the business, if there are no particular direct and immediate problems which occasion such a visit.

Q. When your firm accepts a new audit engagement, do you expect the staff assigned to that engagement to become generally familiar with the trade or industry in which the client is engaged, either before they go into the job, or before they finish it?

A. Yes.

Q. Do you expect your juniors to be sufficiently familiar with the type of documents with which they are apt to come in contact with as to be able to recognize what we may call significant irregularities in the documents, such as, for example, on checks the absence of the date or the absence of endorsements that are necessary?

A. Juniors work under the constant direction of experienced assistants and are trained gradually through repeated experience to look for the essential characteristics of documents purporting to reflect bona fide transactions.

Q. Do you expect them to report any irregularities they find and be alert to discover them also?

A. We do expect the staff to be alert, to note and report departures from normal characteristics of documents supporting transactions.

Q. What instructions do you give them as to handling such irregularities when they are discovered? Do you tell them to take it up with the client, or how is that worked?

A. When irregularities are noted, they are discussed at once with the senior in charge. Trivial errors in routine matters, although noted, may not go beyond the senior, if he satisfies himself that such is the case.

The more serious matters are brought to the attention of the supervisor or partner in charge of the engagement. Such matters become the subject of discussion between the partner and the client. It may be a matter of incorrect treatment of a transaction, subject to adjustment, if material. In such an event the adjustment is insisted upon. It may be a transaction of unusual character with-

out precedent in the company in which event the discussion may result in the determination of correct policy.

It may be a matter of judgment in which event the partner would not insist upon a conclusion contrary to that of management unless the latter were manifestly unsound or incorrect.

It may be a matter of characteristically careless or incorrect treatment of certain classes of transactions, in which event the sampling and testing of further details would be undertaken with or without the consent of the management.

These are examples of the constantly recurring matters which require the application of judgment and opinion which are typical of accounting practice.

IV. CONDUCT OF THE EXAMINATION

A. INTERNAL CHECK AND CONTROL

Q. Now, turning for a while to the question of what may be called internal check and control. To what extent do you require the members of your staff who are assigned to a particular engagement to become familiar with the particulars concerning which they are auditing? That is, if it is a plant, the plant layout, the operating methods, the nature of the products, the character of the personnel, that sort of thing.

A. Not every junior and assistant engaged on an assignment will become thoroughly familiar with the plant layout, operating methods, nature of products, and characters of personnel other than to the extent to which he may assimilate such knowledge incident to the routine duties which he performs.

The supervisor and partner in charge of the engagement are expected to familiarize themselves generally with these things as an essential background to the formation of an opinion on the financial statements and to a comprehension of the system of internal control in order to judge the adequacy of prescribed methods.

Obviously, this implies the character of knowledge concerning technical operations which ordinary business judgment would permit; but, in no sense implies the type of knowledge which lies within the scope of engineering or other specialized technique.

Q. In connection with obtaining the knowledge about the particular concern do you have as a practice, the obtaining of an organization chart or the preparation of its equivalent?

A. Yes. Incident to our survey of the system of accounting and internal control, we obtain, or prepare, an organization chart or a classified list of personnel indicating titles and functional services performed in the financial and the accounting operations.

Q. Do you expect that chart to be prepared in connection with each audit, or brought up to date for each audit, or what?

A. That chart or list is part of our permanent file on the engagement and is reviewed annually, and such changes are made as are necessary to keep it up to date.

Q. I see. Now, what do you understand this term "internal check and control" to mean? What are the common basic features of such a system? Why do you have it, what does it do, and so forth?

A. In answering this question I should like to quote from an article which I prepared for the National Association of Cost Accountants and which appeared in the bulletin of said organization dated April 1, 1936:

Internal audit control may be defined as the arrangement of routine whereby the work of each employee is counterchecked by the work of another employee. A complete system of countercheck presupposes an organization large enough to warrant departmental segregation of accounting functions. Complete control of all details is rarely found even in the largest organizations, nor is it suggested because the cost of safeguarding certain types of transactions may be greater than the losses which might arise through the absence of such safeguards. The problem is one of evaluating the hazards and of establishing safeguards commensurate with the hazards.

I have used the term "internal audit control" in the foregoing quotation as synonymous with the term "internal check and control."

As a matter of fact, internal check and control should be distinguished from internal audit. The former relates to prescribed routine, whereas the latter term relates to those steps which are undertaken to confirm the effectiveness of prescribed routine.

In the article referred to previously, I also made the following statement:

Technically, the internal auditor exercises a function which should be divorced from all other entangling alliances. The comptroller should be responsible directly to the Board of Directors and the internal auditor should be responsible directly to the comptroller only. The results of the examinations conducted by internal auditors should be reported in writing by the internal auditors, the report should be used by the comptroller as a basis for remedial measures and should be retained for review by the external auditors. These reports, or other evidences of internal audits may serve the external auditor in expediting tests of the effectiveness of the system of internal control and in general the line of authority and responsibility, the rotation of employees, the retention of internal audit reports, will have a material bearing upon the character of examination undertaken by the external auditors.

Typical of some of the basic features of a system of internal control, it is rudimentary that the functions of cashing and the maintenance of accounts receivable ledgers should be separate functional divisions in the accounting department.

Bookkeepers engaged on such ledgers should have no connection with the cashier's work and, on the other hand, cashiers should have no access to ledgers nor to statements sent to customers.

Similarly in connection with pay rolls, the functions of time-keeping, preparing pay rolls, and pay-offs, should not be controlled under one employee. This work should be performed by different employees or departments and should be checked independently, preferably before pay rolls are released.

The example most commonly cited relates to what is known as the imprest system of cash funds. Proper control forbids the disbursement of funds emanating directly from cash receipts. All cash disbursements should be made from imprest funds. Under such a system the amount of the fund should be fixed at the smallest possible amount commensurate with the requirements, and reports of disbursements should be made periodically, such disbursements should be reimbursed on the basis of supporting vouchers by checks drawn on the general fund in order to restore the fixed total of the imprest fund periodically.

The N. A. C. A. Bulletin to which I referred previously, includes reference to many other typical details of internal control and internal audit. The reference is the bulletin of April 1, 1936, volume 17, No. 15, section I.

Q. When you referred there to cash disbursements being made from these funds, you meant disbursements in actual cash?

A. Disbursements in actual cash.

Q. As distinguished from checks?

A. As distinguished from checks.

Q. Now, on page 7 of the bulletin, Mr. Stempf, there is a statement that the nature and extent of the examination; that is, the scope of the audit, depends upon the purpose of the examination, the amount of detail to be included in the statements covered by the reports, the type of business, the accounts of which are being examined and the system of internal check and control.

What is your understanding of the effect of each of these factors on the scope of the audit?

A. In my previous answers to questions I have referred briefly to the distinctions between audits, examinations of financial statements, and investigations. As to the purpose of the examination, in an examination made specifically for the purpose of corroborating the cost of capital additions during a year, obviously only such accounts would be examined as affected capital expenditures. One would not deal with unrelated assets and liabilities or operations at all.

On the other hand, in an examination of financial statements made for purposes of the annual report to stockholders, a much broader program contemplating the examination of all of the accounts presented in the balance sheet and a general review of the operating accounts should be considered.

As to the amount of detail included in the statements to be covered by this report, on page 7 of the bulletin, reference is made to the fact that:

A statement which shows the analysis of the cost of sales or of the selling, general, and administrative expenses, will necessitate a closer review than would be required were a more condensed statement to be furnished.

The same would be true even in greater degree in the case of a report requiring departmental analysis of operations necessitating further corroboration of the departmental classification of expenditures and added consideration of the propriety of the bases used in the apportionment of joint expenses of departments, etc.

As to type of business, the accounts of which are to be examined, the natural difference in the characteristics of companies requires a difference in emphasis upon those balance sheet classifications and details of operations. For example, in a retailing establishment where all goods are purchased, the substantiation of cost relates primarily to purchase invoice prices. Whereas, in a manufacturing business, one is confronted with the corroboration of the elements of production costs.

Similarly, in a heavy goods industry, the investment in plant and equipment and maintenance thereof are of relatively major importance, whereas in certain service organizations there is practically

no investment in plant and facilities other than in office furniture and fixtures and the element of capital investment and maintenance thereof are relatively negligible.

Again, such service organizations usually have no inventory other than office supplies, etc., as opposed to the major importance of inventories in any manufacturing concern.

As to the system of internal check and control, in my opinion, it has been the accepted practice for many years by public accountants to consider the adequacy of the system of internal control in determining the extent of the examination required to satisfy themselves as to the accuracy of the records.

In dealing with the subject of influence of internal control upon audit procedures in an article which I prepared for the *Journal of Accountancy*, which appeared in the issue of September 1936, I made the following statement:

In deciding the amount of testing and sampling undertaken by the independent public accountant, and in checking the effectiveness of the system of internal control, the circumstances of each case must be considered. The characteristics of the business, the form of the records, and the use of mechanical equipment are all factors which influence the extent of such examination. The element of judgment is of major importance and the accuracy of the external audit will be affected greatly by the accountant's technique in examining this phase of the work.

I said also in that article:

The work of the internal auditor may not be substituted for that of the public accountant, but all evidence which the comptroller may produce in support of his representations that internal control is effective will influence the extent of the related work undertaken by the public accountant. On the other hand, the periodic examination conducted by the public accountant does not take the place effectively of the constant vigilance of the internal auditing. The two are complementary. The functions of the two should be coordinated to minimize the detailed checking to be undertaken by the public accountant. The reports of internal auditors to the comptroller with underlying working papers should be retained for review by the public accountant. Such working papers, if properly prepared, will expedite the rechecking of supporting evidence. Similarly, the internal audit staff may lend substantial assistance in the preparation of analyses and assembling corroborative documentary evidence which will facilitate the work of the public accountant.

I think it should be emphasized that complete systems of internal control and internal audit are rarely found in small and medium-sized companies. Even in the largest organizations perfect control of all details cannot be accomplished as the cost involved would probably exceed greatly the possible losses incurred through lack of such control.

The controlling factor for both large and small enterprises obviously should be to reduce the possibility of loss to a minimum at a commensurate and reasonable cost.

To demonstrate the necessity for the exercise of judgment in reliance upon internal control and internal audit, I need only point out the wide difference which exists in comparative cases. In a case in which the comptroller is responsible directly to the board of directors and devotes himself solely to the functions of comptroller, and where he has under him a competent corps of internal auditors who report directly to him, the degree of independence and reliability of the work done under his direction is quite different from that existing in a situation in which the comptroller's duties are confused with other

functional responsibilities; where he does not have the same degree of independence, where he reports to some other officer of the corporation, and is subject to his instructions, and where he has a limited number of relatively unskilled men at his service in the conduct of the internal audit.

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

AFTER RECESS

Q. (By Mr. WERNTZ.) Now, the bulletin indicates in one or two places, Mr. Stempf, that section II is designed for small or moderate sized businesses, and that for large ones the modifications of section III have to be considered. What in your opinion distinguishes a small business from a large business? Is it the volume of assets or volume of transactions or size of the transactions, or what?

A. Generally it is a combination of all of these factors. In my opinion it is not so much any one of these factors that would govern the modification of the audit media set forth in section II of the bulletin as it is a matter of the accounting methods used and the degree of existing internal control and internal audit.

If internal control and internal audit are lacking, it seems to me to follow that the independent public accountant must necessarily examine more detail than in cases where he has satisfied himself as to the effectiveness of internal control.

Similarly, as the effectiveness of internal control and internal audit approaches the ideal, the auditor may curtail the extent of his detailed examination.

Q. Then you would say that to some extent at least the term "size" means rather the degree of efficiency of the system of internal control?

A. That is right, it is basic that the degree to which a company can sustain a sound comptroller's department and a sound internal auditing organization depends upon its size. The volume of its business and the element of expense naturally are also factors that have to be considered.

Q. And on the number of persons that are necessary to record the transactions, etc.?

A. That is correct.

Q. Now, at page 9 in the bulletin, it is also indicated that the extent of the examination is to be determined in part from the accountant's knowledge of the individual situation. What do you understand to be the extent of the knowledge of the individual situation which the accountant should have, either before he starts his examination or before he finishes his first one. How much should he know about that?

A. In my opinion, the extent of the knowledge of the independent public accountant in respect of a given situation relates to his judgment as to the adequacy of internal check and control modified by his judgment of the competence of personnel, his judgment of the degree of independence of the comptroller, and such other reactions as a reasonable man would form under the circumstances.

I have in mind that in connection with the survey of internal control, usually undertaken at the time of an initial engagement, the men who conduct such a survey by reason of their contact with individuals would form an impression of their intelligence and capacity, and by their casual testing of the operations of the system, would form some opinion as to the intelligence and accuracy with which the transactions are recorded and the degree to which the prescribed system is observed.

Q. What method does your firm employ for the developing of the information about a client's accounting procedure, its system of internal control?

A. On initial engagements we conduct a general survey of the system of internal control relying primarily upon the explanations of department heads and employees handling the various functions, but examining also the procedure in actual operation, making random tests of a number of items.

The results of this survey are reflected in a permanent file outlining the system in use. In recurring examinations our program of examination provides for a review of the system in use in connection with the actual audit; providing for the revision of the permanent file record relative to the system where necessary, with a running record of observations as to the continuing adequacy of the system.

Q. Do you utilize a questionnaire of any sort in developing that information?

A. I have dealt with this question briefly in my response to the previous question. We do not use any independent questionnaire relating to internal check and control. On the contrary, there are instructional provisions embodied in the audit program which relate specifically to matters of internal control, requiring observation of specific factors of control and providing for a nominal testing of details to determine the effectiveness of prescribed routine.

Thus we have special instructions which relate to cash receipts, cash disbursements, accounts receivable, inventories, intercompany and branch office accounts, accounts payable, etc., as well as miscellaneous instructions relating to such matters as records of employees, vacations, bonding of officers and employees, provision for joint access to safe deposits, custodianship of notes receivable and securities, signatures and countersignatures, appropriations for capital expenditures, etc.

Actual audit steps also require inspection of documents and related approvals which afford further media for the determination of the effectiveness of internal control.

These provisions are quite detailed in the *Journal of Accountancy* of September 1936, to which I have previously referred, containing illustrative methods of internal control and related tests of compliance which are typical of the instructions observed in our own practice.

Q. You referred to instructional provisions. Do you mean by that that you have some sort of audit program for the job which requires the men engaged to do certain work in connection with these items which you have mentioned?

A. That is correct. I distinguish between instructional provisions and questionnaires in this way: That a questionnaire may be covered

by mere inquiry and recording of the response, whereas instructional provisions require some specific steps to be done, some work to be done.

Q. Do those instructional provisions require answers in writing, for example, as to what was done and what was found?

A. They provide for an initialling by the man who has taken that particular step.

Do you record the information he has obtained or his impression or judgment?

A. That is correct, both in the audit program and on detailed memoranda which become part of the permanent file relating to internal control.

Q. Could you indicate, if you can remember just one item, one of these instructional items and what you might expect to get as an answer, just to clarify this form here?

A. Here is one that relates to collections received directly by cashiers in connection with cash:

A cash register or other mechanical device should be used to record amounts received directly at cashiers' windows from customers in settlement of accounts, etc. The total reading of the registers should be made and compared by an employee other than a member of the cashiers' department with the cashiers' record of cash receipts.

That requires an investigation, a discussion, an examination of retained record in order to initial that item of the internal audit program.

Q. In getting the information or making the inquiries for the men to satisfy themselves as to the instructional provisions, do you have any instructions as to whether they should contact administrative officials or supervisors of particular operations, or the people who actually do the work, or do you leave that to the discretion of the man involved?

A. As outlined generally in the two preceding questions, we satisfy ourselves that the accounting procedures are in fact being followed by inquiries from company employees and discussion with our supervisors, supplemented by random tests of details.

Q. If you find weaknesses in the audit procedure or the system of internal control, do you feel that those weaknesses require further steps or additional steps in your audit program? Can you give a few illustrations if you so feel?

A. If weaknesses are found, additional audit steps are required. For example, purchase invoices should not be approved by an executive for payment unless the goods or services shown on the invoice are supported by a proper purchase order, and are billed in accordance with the terms, prices, and other conditions shown on the purchase order, and there should be an approval on the supporting documents indicating that the goods have been received and are of the type, quantity, and quality billed on the invoice.

The supporting documents should also bear an approval indicating that all extensions, footings, and other calculations on the invoice have been verified, and a further approval indicating the account to which such purchases are to be charged.

When the examination of purchase invoices discloses a recurring omission of one or more of these significant approvals, an examina-

tion of further details may be indicated. It is quite usual to proceed with such additional details without discussing the subject with the company.

On the other hand, an examination of expenditures relating to capital additions and maintenance may indicate theoretically incorrect classifications of such additions, by reason of a failure to observe the distinction between these two classes.

In certain cases this might necessitate a protracted examination of additional detail, necessitating a discussion of the subject with the client, and in such event it becomes necessary to persuade the client of the necessity for such additional examination and correction. In the event of objection by the client, we would nevertheless undertake sufficient additional work to enable us to form a considered opinion as to the correctness of the accounts.

Q. When you have completed your verification of the system of internal check and control, do you think that should result in a thorough knowledge on the part of the auditor of the accounting system followed, the documents that are supposed to accompany each step in the accounting procedure, the papers connected with those documents, etc., that is, the paper work of the company?

A. You have used the word "verification" in the question as you originally submitted it to me and I wanted to offer a comment on the use of that word, if I may do so. I dislike the use of the word "verification," which in its primary sense I believe denotes the establishment of a representation as a reality or a verity. In other words, unassailable truth or fact; whereas the auditor's scope is rather to establish the fairness of representations made as distinguished from their absolute verity.

All accounting matters involving, as they do, the elements of judgment and opinion preclude the assumption of responsibility as to absolute truth. The independent public accountant's examination of the system of internal control relates rather to a corroboration (that is to strengthen as a conviction) of his belief that such system is sufficient.

Such examination of the system of internal check and control should provide a reasonable working knowledge respecting the usual documents, vouchers, and other papers supporting the usual steps, the prescribed procedure and similarly an adequate knowledge of the accounting system followed.

In my opinion, the word "thorough" is a little too strong, as it may contemplate a comprehensive knowledge respecting all variations in transactions. While it is true that a great majority of business transactions follow in a large degree a uniform pattern, infinite variations, nevertheless, exist.

Q. Do you think an examination of the type contemplated by this bulletin should disclose the existence of fraud in the accounts?

A. The type of work undertaken in an examination of financial statements, in my opinion, is not designed to disclose fraud, although it should in ordinary cases and particularly in the absence of collusion assist in minimizing fraud.

This type of examination relies upon the essential honesty of management and, based upon such reliance, necessarily seeks to provide safeguards commensurate with the hazards at a cost reasonably

within the limits of prudent economy. It is recognized that added protection could be afforded with additional cost, but the type of examination required to protect more adequately against fraud would necessitate the examination of much more detail and would therefore be proportionately more expensive, although the type of work done in an examination of the financial statements should serve to satisfy the auditor as to the general accuracy and integrity of the records, the work does not contemplate a complete checking of the classifications of expenditure which would be necessary to detect manipulation of accounts or understatement of assets particularly as to amounts which are not sufficient to distort the accounts to an obvious degree.

Q. Would you say that the accountant before he signs his certificate should be satisfied as to the general accuracy and integrity of the records?

A. That is correct.

Q. That is, to his own satisfaction?

A. That is right.

Q. Within the scope of the examination contemplated by this bulletin, would you say that the auditor should be alert to detect fraud or other irregularities?

A. Yes.

Q. But, of course, that would not extend to the parts of the records which he may not have examined?

A. That is right.

Q. In conformity with his audit procedure?

A. Yes.

Q. So speaking generally, Mr. Stempf, what is your practice as to making test examinations of records covering certain items of transactions such as sales, for example. Do you feel that these tests, if the results are satisfactory and adequate to establish to your own satisfaction the records as a whole, do you feel that they verify the records not examined, if they are not conclusive, do you think such tests ought to be relied upon?

A. We do make tests of all of the items mentioned in the question as well as others. I do believe that such tests, if the results are satisfactory, do adequately corroborate the records as a whole relating to such transactions. By no means do such procedures conclusively verify the records not examined. Although such tests are not conclusive, nevertheless they should be relied upon by reason of the underlying philosophy of such examination which seeks to provide effective safeguards against probable hazards at a commensurate cost.

It seems pertinent to point out that in the great majority of cases, the auditing procedures suggested in the bulletin have proved adequate for the purposes for which they were intended.

B. CASH

Q. Now, let us turn to the details of an audit program. Take first the question of cash. Do you feel that the cash program outlined on pages 11 and 12 is a minimum or maximum and would you indicate also any steps therein which you customarily omit or any steps which you generally add?

A. Generally speaking, we consider the provisions of the bulletin a minimum rather than a maximum. Item 5 under the classification of cash appearing on page 11 of the bulletin provides two methods. We use the alternative.

Q. Just there, would you say the alternative is more extensive than the optional method?

A. Yes, it is.

Q. Will you continue?

A. Where practicable, we seek to strengthen the provisions of the bulletin relating to the confirmation of cash by obtaining bank statements, checks, and vouchers directly from the banks at a date not earlier than the 15th of the month following the date of the balance sheet.

Q. Now, on page 33, there is a reference to the reconciliation of bank accounts by employees who are independent of the cashier's department. How important do you think that is?

A. The factor of independent check is inherent in all phases of internal control and it is more highly desirable that bank accounts be reconciled by employees independent of the cashier's department.

Q. Is that equally true in the case of small working funds and the major general funds of the corporation?

A. Naturally not. In minor working funds I think it would suffice to have the man who maintains the records in respect of the bank account A reconcile those relating to B, and vice versa within the department, perhaps.

Q. Now, again back to item 8 on page 12, the last sentence of that item indicates that in certain instances a comparison of deposits should be extended to include a check of original deposit slips or authenticated copies. What would be those circumstances, and do you insist upon that procedure in your practice?

A. If the count of cash is made immediately at the close of the year the undeposited items are deposited under our supervision, we do not require this audit test. On the other hand, in connection with outstanding checks appearing in the reconciliation and representing transfers between banks, we do trace each of such items in the deposit in other banks. In this connection also, in connection with checks representing transfers between banks, our program provides for a notation of the dates of such checks, dates of payment by banks and dates of entries in the cash books, both as to withdrawal and deposit, seeking to detect checks drawn after the close of the period but included as deposits in other banks prior to the close of the period and not included in the reconciliation as an outstanding check.

Also in connection with our test of internal control but not as to the last 2 or 3 days of the period, we do test the deposits of receipts in the bank and do compare itemized amounts on duplicate deposit slips, or if circumstances warrant, on copies of original slips obtained directly from banks with corresponding entries in the cash receipts book, seeking to detect collections withheld from books to cover shortages.

Otherwise, generally speaking, the procedures in respect to the corroboration of cash coincide with those suggested in the bulletin.

Q. Now, you indicated that if cash were counted at the cut-off date, you wouldn't feel this additional step was necessary. Do you

imply that if it was not counted at that time, you would think this step was necessary?

A. That is correct. We try to be present at the count of cash at the close of business on the last day of business for the period under review.

Q. In the last part of your answer you mentioned if circumstances warrant, you would make a comparison of deposits with duplicate slips from the bank. Would you indicate what you had in mind when you said if circumstances warrant; is that a usual procedure?

A. It is an unusual procedure. It would be done where we had not been present at the cash count at the close of the year, or where any factor of prescribed routine had not been observed, where full details of deposit of checks were not shown on deposit slips or something of that sort, but only totals shown, then we might revert to the original deposit slips filed with the bank.

Q. In your original answer, were you referring to deposits other than the dates of the cut-off, that is, back through the year?

A. Yes; we do it as part of our internal control check.

Q. And you would have the same circumstances in mind back there?

A. That is correct.

Q. Now, in item 8 again in the third line, the term "bona fide receipts" appears. What does that term mean, in your opinion, and how do you establish the bona fides?

A. I believe that the term bona fide is explained in my answer to the previous question, where I refer to collections deposited in the banks but withheld from the books to cover shortages.

Similarly, funds deposited immediately before the close of the year and withdrawn immediately after the close of the year would lack bona fides. Generally speaking, the term bona fide receipts relates to the normal and regular receipts which a company would ordinarily receive from customers and others, whether in payment of sales, repayment of advances, refunds, or otherwise. Miscellaneous receipts such as sales of scrap, insurance claims, and income from miscellaneous sources under properly established internal control should be reported to the accounting department by the recipient independently of the report which accompanies the cash to the cashier. The accounting department would compare the sales on its report with the cashier's record of receipts and such memoranda should be retained for subsequent inspection of external auditors.

Q. Now, Mr. Stempf, turning to the proposition of cash in bank for a moment. Do you feel that it is proper to include in cash in bank amounts due from foreign banks or from private bankers under all circumstances?

A. In my opinion, it is customary and proper to include in cash amounts due from foreign banks and from private bankers unless special circumstances exist such as currency restrictions in foreign countries, in which event such foreign balances would normally be excluded from unrestricted cash.

Similarly, cash in closed banks should likewise be excluded from regular cash. The usual forms of confirmation requests require replies which should state whether the balances are subject to withdrawal by check as well as the related fact as whether such balances are free from liens or offsets.

Q. How about the question of exchange restrictions? How do you determine that?

A. It is a matter generally of common knowledge through the press or by a discussion with officers of the client corporation or by actual observations of the fact that no transfers, no remittances have come when they are obviously available.

Q. Do you contemplate there an actual step in the procedure which would see to it that the factor is considered in regard to balances held abroad?

A. That is correct.

Q. How do you determine that a particular person is, in fact, a bank? What do you rely on there?

A. We ordinarily rely upon resolutions of boards of directors authorizing the establishment of such accounts and designating those who are authorized to sign checks. In the absence of suspicion of irregularity, I would consider that sufficient.

Q. In your practice, do you customarily find that the boards of directors have such resolutions in connection with all bank accounts?

A. It has been my observation for many years that banks require certified copies of such resolutions before they recognize the establishment of the account and recognize the authorized signatures.

Q. What do you do if you should find that no such resolution is in the minutes? What is your practice there, if that is purely theoretical?

A. Yes; it is possible that in small outlying banks, that formality might be overlooked by the bank and in turn that the client may not have adopted the necessary resolution, in which event, in order to provide for an observance of established procedure, we would obviously call the matter to the attention of the treasurer of the company or another officer and suggest that such a resolution should be recorded in order that we may have something to rely upon as to authorized signatures.

Q. Do you rely to any extent upon the receipt of customary forms from the bank, that is, canceled checks, what we would call usual bank forms, statements, and so forth, the usual things that might come from dealing with the bank?

A. Naturally, in the conduct of our audit, if we found anything exceptional or unusual in the forms that came from banks, we would make inquiry to satisfy ourselves that things were regular.

C. ACCOUNTS AND NOTES RECEIVABLE

Q. Now, turning to accounts and notes receivable for a moment. In items 3, 5, and 6 under accounts receivable the pamphlet indicates the necessity of making inquiries as to particular matters. Would you describe briefly how and from what persons you obtained this necessary information?

A. Matters relating to credits and collections would be discussed with the head of the credit department. Matters relating to adjustments and disputes would be discussed with the head of the sales or engineering department, or if a separate adjustment department is maintained, with the head of such department. Trade discounts are usually a matter of established policy administered by the sales department and should therefore possibly be discussed with the sales

manager or one of his authorized assistants. Generally, all of these matters relate to functional responsibilities which come under the general supervision of the treasurer and may require discussion of the subject with him. Administrative duties and operating policies vary in different businesses and the circumstances in each case would necessarily govern.

Q. And now, turning to item 3 for a moment, the first sentence of that reads: "Examine the composition of outstanding balances." What do you do in respect to that?

A. In my opinion, this relates to the work ordinarily undertaken with the so-called aging schedules of receivables, contemplating the analysis of receivables in a classified summary as to current accounts and those past due, in varying degree, as well as a general determination of the items constituting the unpaid balances.

The character of this analysis depends upon the practice of customers to remit in respect to specific invoices or to make payment on account.

Q. Now, in making up your aging schedules, do you make those up yourself or do you use the ones made up by the clients?

A. Preferably, the aging schedules should be prepared by the client and which we then subject to appropriate tests.

Q. To see that they are in agreement with the records?

A. That is right.

Q. In making that examination do you expect the general condition of the account to be noticed; that is, such matters as unusual allowance, write-offs, concentration of charges in particular months, and so forth?

A. Yes. Principally from a scrutiny of the accounts receivable controlling accounts. Such scrutiny should be made to ascertain that they appear regular, to guard against fictitious items, paying particular attention to entries during the last 2 months. In general, this is done by ascertaining whether debits to accounts receivable for sales fluctuate only in accordance with usual seasonal business and by investigating items which appear abnormal. By investigating credits representing sales returns and allowances, where the amounts appear abnormal, by determining that cash receipts are reasonably regular and by investigating items that appear unusual, by a scrutiny of journal entries of substantial amounts and investigation of those which appear unusual with similar scrutiny and investigation of sales returns and allowances for the period subsequent to the closing date. Similarly, by using the aging as a basis, referring to the credit department or general files of claims, correspondence, and so forth, usually provides information regarding questionable or disputed items.

Q. There is one thing I am not quite clear about there. How far back do you carry the examination in connection with the aging?

A. As far back as may be necessary to determine the composition of the balances, although we usually end at accounts 1 year or more old. The chances are that if they are more than a year old, they have been fully reserved against or have been written off.

Q. That is what I had in mind. Now, at the top of page 15 in the bulletin, you will find this sentence:

Referring to confirmation of accounts receivable, with the customer, while such confirmation is frequently considered unnecessary in the case of companies

having an adequate system of internal check, it is one of the most effective means of disclosing irregularities.

Do you understand that sentence to mean that receivables ordinarily should be confirmed or, if not, would there be circumstances under which they should be confirmed, such as the concentration of very large balances in a few accounts?

A. I think the quoted sentence should be considered in connection with the sentence preceding it which says:

The best verification of accounts receivable is to communicate directly with the debtor regarding the existence of the debt.

Also the sentence which immediately follows the one previously quoted says:

If it is to be undertaken, mail personally the request for confirmations, et cetera.

It has always seemed to me that item 7, as a whole, appearing on pages 14 and 15 of the bulletin, was intended as a recommendation to be adopted if practicable, although in no sense mandatory.

In our own practice, we do use confirmations in a great many cases. Where accounts are relatively few in number and large in amount it would ordinarily be a relatively simple matter to apply this audit step.

Q. In your opinion how, if at all, does the past credit and adjustment record of individual accounts affect the desirability of making confirmation? Do you feel that that has any bearing?

A. Only in exceptional cases would it be practical to investigate the past credit and adjustment record of individual accounts in connection with those presently under review in an examination of financial statements unless such conditions are indicated by the condition of the accounts scrutinized at the time of the audit.

In the latter case, it would indicate that discussion of the account with the credit department or other pertinent executives of the business should be had. Collections on accounts receivable subsequent to the date of the balance sheet, but prior to the completion of the audit, do affect our judgment, particularly if they are supported by correspondence or other documentary evidence.

In the final analysis, in my opinion, such evidence is circumstantial and not conclusive unless the entire audit is extended to a date reasonably beyond the date of the balance sheet to comprehend the transactions which are relied upon to corroborate the final condition at the date of the balance sheet.

Q. Now, considering the question of confirmation directly. There are several possible methods by which that could be conducted. For example, positive confirmation of as many receivables as possible; the negative confirmation of all receivables, or the positive confirmation of part of them, particularly the larger ones and possibly a sample confirmation of the balance.

What is your thought as to the relative value of those tests?

A. The most desirable of these three forms of confirmation is, obviously, the positive confirmation of as many accounts as may be possible. Next in order would be the fair sampling of accounts and the least desirable would be the negative type of confirmation. Although the latter form may be the only practical measure if confirmation is sought of a great number of accounts, all of which are relatively

small and like in amount and are reasonably regular in payment, such as might arise in connection with service contracts, subscribers, or public utility consumers.

Q. Now, looking at page 34, under "Accounts Receivable" and also at page 8, there is a reference made to safeguards surrounding the handling of incoming mail, the mailing of statements to customers, the handling of remittances, and so forth. In that connection, what inquiries, or tests, do you make? Do you actually find out whether statements are mailed to customers? Do you feel that actual mailing, for example, is some assurance that the accounts are correct?

A. Ideally, a responsible employee not associated with the cashier's department should supervise the opening of the mail and prepare for subsequent review by the accounting department an independent list of cash received in this manner. In practice, this safeguard is provided in many different ways and in varying degrees. It is our practice to review with the pertinent department heads and the employees who handle such matters the procedures which are regularly followed, if possible to observe the procedure and to check such records as may be available in respect to remittances, passing from the mailing department to the cashier's department.

With respect to the mailing of customers' monthly statements, we discuss the established routines with the head of the accounts receivable section. If possible, we try to observe the preparation of monthly statements, and customarily confirm at least a representative percentage in amount and number of accounts of such receivables.

We do consider the mailing of statements at least partial assurance that the accounts are authentic, particularly if such statements are prepared and mailed by an accounts receivable section which is clearly independent of the cashier's department or even better, if such statements, although prepared in the accounts receivable department are checked by a representative of the comptroller's department before being actually mailed.

Q. I see. Now, when you speak of confirming receivables there, referring to the last sentence or two of your answer, do you refer to confirmation by correspondence with the customers?

A. That is correct.

Q. Now, again on page 34, there is an indication that under certain circumstances a relatively limited test of the individual customers' accounts may suffice. What do you understand that to mean?

A. This would depend upon the circumstances surrounding the particular case. If the review of the system and a random test of a number of items indicate the desirability therefor, we apply a variety of limited tests. We might check postings from detailed receivables to cash, sales, and other records for a number of weeks or even months, although this work would ordinarily be omitted on large engagements where machine bookkeeping is used and, particularly, where average balances are small and where the control appears to be effective.

We usually vouch in limited degree the sales and sales returns and allowances as well as other classes of debits and credits to customers' accounts. We usually secure from the company's counsel or legal department a list of collections effected during recent

months relating to accounts previously written off and compare such lists with amounts recorded on the books as recovered from bad debts or, if this is impractical, we resort to an examination of correspondence and collection files.

In the aging of the accounts receivable under such circumstances and where accounts are great in number, we should probably limit the aging to a representative percentage of the accounts upon the basis of the time elapsed since maturity in respect of balances under a predetermined amount by aging balances in excess of such an amount in detail. Percentages of past dues developed by such sampling would then be applied as a measure of relative past dues probably reflected in accounts not aged as a measure of the adequacy of the reserve provided.

I have previously referred to the scrutiny of the controlling accounts of individual ledgers to assure that they appear regular and I have also referred to a consideration of the fluctuation of sales in accordance with the usual seasonal business and the investigation of items which appear to be abnormal. These are merely typical of the things that would be done under such limitations of the examination of receivables.

Q. Going back for a moment to the question of confirming receivables, I believe you indicated that you do make such a confirmation in a considerable number of cases. Is that correct?

A. That is correct.

Q. Have you found in those cases any difficulty in getting in your confirmations; any particular difficulty?

A. It sometimes requires two or three follow-ups to assure the return of a representative portion of the number sent out, but we do pursue such follow-ups.

Q. You do. Now, turning to notes receivable. If you determined in a particular case that it was unnecessary to make confirmation of open accounts, would that control your decision as to notes growing out of open accounts?

A. Generally speaking, my answer to this question is, yes. Although we do, in a great many instances, confirm a representative portion of both notes and accounts receivable.

Q. Now, at the bottom of page 33, the statement appears under "Notes Receivable":

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

Do you think it is necessary to confirm notes under those circumstances?

A. Under such circumstances we would not consider it necessary to confirm the notes receivable.

Q. What would be the major features of a satisfactory system of internal check in that connection?

A. As a typical example, practically all moderate sized and even smaller auto finance companies maintain a corps of car check men whose duties it is to determine by independent inspection that a car bearing the serial number indicated on a note receivable does actually exist and that a person of the name appearing on the note lives at the address recorded. Reports are filed regularly by these men in support of the notes receivable in the portfolio of the company.

Analogous procedures are provided for in respect to notes receivable taken in connection with industrial and home equipment. Naturally, conditions vary in individual companies but a review of the internal control, coupled with the regular audit steps undertaken, suffices to enable an exercise of judgment as to the degree to which one may rely upon the records regularly maintained without recourse to independent confirmation.

Q. In such circumstances, would it be customary for you to examine the notes receivable themselves that the company has in its files?

A. Only by tests, depending upon the size of the company and the degree of internal control.

Q. You would insist upon those tests no matter where the notes physically were located, would you?

A. That has been our practice. On the other hand, in some of the companies, those notes are pledged with banks in connection with loans and there we rely upon the confirmation from the banks.

D. INVENTORIES

Q. I see. Now, turning to the question of inventories, Mr. Stempf, do you feel that an accountant is responsible for the pricing of inventory in accordance with generally accepted accounting principles?

A. In my opinion the accountant has a responsibility to undertake such work to satisfy himself that the representations of management, as to the pricing of inventory in accordance with generally accepted accounting principles, are fairly stated. Such corroboration is obtained primarily from supporting documentary evidence and also by means of explanations and information which he has obtained by discussion of the subject with officers and employees of the company.

Q. Now, one of the tests—one of the methods of inventory that is frequently used calls for cost or market, whichever is lower. What is meant in that connection by "market price" in your opinion?

A. In respect to manufactured products, market price means, academically, the lowest of three bases, A, the cost to reproduce, with current market for raw materials and current labor and overhead costs; B, purchase cost of finished products, if bought outside; and C, sales price, less provision for selling and administrative expenses and possibly a normal profit.

The circumstances surrounding the individual case govern the practical applicability of these bases; obviously purchase cost for a like finished product, if bought outside, would not be applicable to any product of distinctive design or character nor would it be appropriate or necessary in determining the merchantable value contemplated by C to provide for normal profit, if, in fact, the company has not been operating profitably theretofore.

In general practice, I believe it is the consensus that provision for selling and administrative expenses sufficient to avoid loss on ultimate sale is adequate. This is, of course, a matter of opinion and judgment.

As to purchased material or goods the replacement price generally determines the phase of market price contemplated in A and in this respect quoted market prices may be applied if they relate to qualities and quantities normally purchased. Otherwise, replacement price may be ascertained by obtaining definite quotations.