

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., Tuesday, February 28, 1939.

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

PROCEEDINGS

The EXAMINER. Mr. Lenhart, will you be sworn?  
Whereupon:

NORMAN J. LENHART

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 the reporter your full name and address?

The WITNESS. Norman J. Lenhart, Summit, N. J.

The EXAMINER. Mr. Lenhart, it is customary at the Commission hearings to apprise a witness of his 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.

Mr. WERTZ. Mr. Examiner, I would like to state for the record that I regret that Mr. Staub has been taken ill and couldn't be here today. I appreciate his cooperation nevertheless.

I. AFFILIATIONS AND BACKGROUND

Q. (By Mr. WERTZ.) Mr. Lenhart, what is your firm affiliation at the present time?

A. I am a partner of Lybrand, Ross Bros. & Montgomery.

Q. For how long?

A. Since October 1, 1929.

Q. How long have you been engaged in accounting work?

A. I have been a public accountant for 23 years, with the exception of 1 year. After I left college in 1916 I immediately started in public accounting work in Chicago. After 4 or 5 years I left public accounting to take charge of the office of a real estate and mortgage company in Chicago. After about 1 year I left this work to return to public accounting and have been a public accountant ever since.

Q. Have you been with your present firm during that period?

A. I have not. For the first 3 years in public accounting I was with Arthur Anderson & Co. Since that time all of my public accounting has been with Lybrand, Ross Bros. & Montgomery.

Q. Are you a certified public accountant?

A. I am.

Q. In what state?

A. By examination in Illinois and by reciprocity in New York, Michigan, and Pennsylvania.

A. Now, going back to your training before you went into public accounting, had you any academic accounting training?

A. I graduated from the University of Illinois with a B. A. degree.

Q. And that included specific courses in accounting?

A. That did.

Q. Could you state in general terms the size and nature of your present firm?

A. The firm has offices in 19 cities in this country and two cities in Europe. There are 32 partners in the firm. The size of the permanent staff and temporary—or peak staff—varies. In recent years the number of employees has not gone below 750 and has exceeded a thousand at the peak.

Q. Could you indicate roughly the type of clients, that is, do you specialize or engage in general accounting business?

A. We render all types of public accounting service and our clients include almost all types of business. In size they range from the largest corporation in the United States to very small concerns. We act as auditors for many companies, the securities of which are listed on the New York Stock Exchange, New York Curb Exchange, and other exchanges. The services rendered by us include income tax and other tax service, audits leading to our signing the American Institute form of report, audits in connection with financing, and granting of credit, special investigations of various kinds, and such special services as cost and budget work, organization and system work, et cetera.

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

A. I am a member of the American Institute of Accountants and the New York State Society of Certified Public Accountants. In times past I have been a member of other state societies of certified public accountants.

Q. Do you hold any offices in any of those societies?

A. I do not.

Q. Have you been active in their committee work?

A. I have served on various committees including for some years the New York State Society committee on practice and procedure.

Q. Have you written for publication on accounting topics?

A. I have written some articles for publication but not to any considerable extent.

Q. Have you done any other accounting work, educational or similar things?

A. No; I wouldn't say so.

Mr. WERNITZ. Off the record.

(Discussion off the record.)

## II. SCOPE OF EXAMINATION OF FINANCIAL STATEMENTS

Q. (By Mr. WERNITZ.) Mr. Lenhart, could you indicate and distinguish the types of services rendered by public accountants which lead to, or result in, the certification of financial statements?

A. In my opinion there is only one general type of accounting service rendered by public accountants which leads to or results in the certification of financial statements. In some instances, the balance sheet only may be certified. In other cases, the balance sheet, income and surplus accounts, may be certified.

In still other cases the financial statements for a number of years may be certified and a very voluminous report rendered in connection with proposed loans or financing.

To a certain degree the examination of the income account is necessary in connection with the certification of the balance sheet only. The difference between the scope of the minimum examination necessary to certify the balance sheet only and the minimum necessary to certify the same balance sheet and also the statements of income and surplus varies according to the circumstances of a particular case.

In some instances, there would be very little difference between the minimum examinations which need be made. In other cases, there might be a substantial difference in the extent of the tests and other work which must be done in order to certify the statement of income as well as the balance sheet.

Q. Do you recognize any difference, say between what is sometimes called the detailed audit and an examination of financial statements for the purpose of certifying?

A. Yes; I do. We make some audits which we term "detailed audits" in which we examine every transaction of the year.

Q. Could those lead to a certification?

A. They could.

Q. Now, what type of service do you render for the preparation of statements under the two acts or for annual reports for credit purposes; is that of the detailed type or the other type you mentioned?

A. The type of service we render in such cases is the general type I described in answer to question 10.

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

A. I am.

Q. Did you, or any members of your firm, participate in the preparation of that pamphlet?

A. Well, under date of May 8, 1934, I wrote a letter to Mr. John L. Carey of the American Institute of Accountants, suggesting the desirability of a revision of the 1929 Federal Reserve Board publication, "Verification of Financial Statements." I was advised by letter that Mr. Carey was out of town, but under date of May 21, 1934, he wrote me that the executive committee of the institute would meet in about 10 days and my letter with reference to the possible revision of the Federal Reserve Bulletin would be considered at that time. It may be that others also had made the same suggestion but in any event a committee was appointed to consider such a revision. After the committee had been at work some time, I made a number of suggestions with respect to the proposed new bulletin and was asked to become a member of the committee, and served on it until the revision was completed.

Q. In your opinion, Mr. Lenhart, what was the purpose of preparing this bulletin?

A. Well, I think my answer to this question must be explained because, in my opinion, the primary purpose of preparing and publishing this bulletin was to forestall publication of some similar bulletin by some other body, governmental or otherwise. I have heard various reasons advanced for the publication in April 1917 of the Federal Reserve Bulletin, entitled "Approved Methods for the Preparation of Balance Sheet Statements."

It is my opinion that one of the reasons for the publication of this first bulletin was the desire to obtain greater uniformity in the accounting practices and principles underlying the preparation of financial statements. I believe the second reason was that there was a rather wide variation in the experience and ability of public accountants throughout the country and it was hoped that the preparation of such a guide or tabulation of certain audit procedures would be helpful to credit grantors by perhaps impressing upon certain less experienced auditors the desirability of doing certain work which, perhaps, they did not customarily do.

At the same time, the bulletin might be of help in persuading clients of auditors to withdraw objections to certain audit procedures which the clients may have felt involved more expense than the circumstances warranted. The Federal Reserve Bulletin was revised in May 1929 and was entitled "Verification of Financial Statements" in place of "Approved Methods for the Preparation of Balance Sheet Statements."

The committee which drafted the January 1936 bulletin entitled "Examination of Financial Statements" gave a great deal of consideration to the possibility of effectively withdrawing or rendering obsolete the then existing bulletin entitled "Verification of Financial Statements" without issuing anything in its place. By 1936 the average competence of public accountants had been greatly improved. Many textbooks were then available dealing with various phases of the auditor's work. Public accounting firms knew that a man might have studied all the available textbooks, have had a brilliant scholastic record, might be able to answer any technical question based upon such textbooks as he had studied, and yet he might prove quite incompetent and unsatisfactory as a public accountant.

As is stated in the pamphlet "Examination of Financial Statements," soundness of judgment is of primary importance in public accounting work. There is a marked tendency, at least in this country, to read and rely on books devoted to how to become skilled in certain lines of endeavor and to believe that by reading such books and following the advice given therein or doing the things which it is suggested should be done, one can become proficient and do competently the things which the book attempts to cover.

Such instruction books or guides cover everything from how to play baseball to how to win friends.

The committee felt that no matter how many words might be put into the revision of the pamphlet then entitled "Verification of Financial Statements," the layman would not understand that a satisfactory audit cannot be made by merely referring to a guide or list of various procedures; that many readers would believe that because a form of audit procedure might be listed it was suggested that such procedure should be followed in every case and, in short,

that an accountant might take the pamphlet in one hand and his brief case in the other and by sufficient reference to the pamphlet perform a satisfactory audit.

Q. Do you believe that in part the bulletin was designed to explain to others than accountants what, in effect, an audit certificate, or an audit, was based upon?

A. I certainly believe the original bulletin was, and I think to some degree the last bulletin is, an instructional pamphlet rather than a guide to the more competent practicing accountants.

Q. Now, in the services that you render, how would you class the examination contemplated by this bulletin?

A. I would class it exactly as the bulletin does, which says:

The suggestions contained in this bulletin are intended to apply to examinations by independent public accountants of financial statements prepared for credit purposes or for annual reports to stockholders.

Q. In such examinations, would you say that the underlying principles of the bulletin are of general application to all sizes and types of companies?

A. In this question we run across the much abused and little understood word "principles." I assume the question means to ask whether the various steps of audit procedure listed in the bulletin should be followed in every type and every size of company. Here again I think the bulletin answers the question in that it gives a list of certain audit steps, some of which may be taken in the case of a small or moderate sized company. It then indicates, in a very general way, the modification and eliminations that might be made in the case of either larger or much smaller organizations.

If question 16 has in mind the general principle that before an auditor should certify he should have reached a satisfactory opinion that the balance sheet fairly states the position of the company and the statements of income and surplus fairly set forth the results of its operations, then I should say that the principles of the bulletin are applicable to companies of all types and sizes.

Q. Would you say that if the steps indicated by the bulletin, which were not applicable, in a particular case, because of the conditions in question, were not present, are deleted, that the remainder would be looked upon more or less as a minimum?

A. More or less, although we, for example, have certain audit procedures not included in the bulletin which we attempt to perform in almost every case so that as to those particular procedures we would not regard it as a minimum.

Q. I see. Do you require the members of your staff to be familiar with this bulletin?

A. We do.

Q. Do you follow it generally as a guide, also?

A. We do not use it as a guide in the sense that we look to it for guidance or that we require the men to follow it, literally, on any engagement.

Q. Well, do you use it as a guide to the general scope of an audit?

A. We do not.

Q. You do not?

How would you compare, generally speaking, the scope of examination of this bulletin with that followed by your firm?

A. In a general way, I should say that the scope of the examination usually followed by my firm is somewhat more comprehensive than that actually outlined in the book. This does not mean that in any examination we would actually go through all the steps outlined in the book but at the same time we might do a great deal more; certainly our objective is the same as the objectives followed by one who in general might follow the general steps outlined in the bulletin.

Q. Speaking historically for a moment, do you feel that the publication of this bulletin led to changes either in your own practice or in auditing practice in general?

A. I think, perhaps, you should distinguish between auditing practice in the larger cities or as followed by the larger firms and other auditing practice. As to the firms in the larger centers, I do not believe it led to any change because I think the bulletin merely puts together certain practices and procedures which were generally agreed upon. Whether it led to any change in general practice, I don't know.

### III. OFFICE METHODS AND STAFF ORGANIZATION AND TRAINING

Q. Now, in these next questions, Mr. Lenhart, I would like you to distinguish the practice or opinions prior to the institution of the present proceedings from any changes that might have resulted since then.

When a new client comes to you, Mr. Lenhart, do you make any independent investigation of his reputation or credit rating either before accepting the engagement or during the course of the first audit?

A. We do not have any set routine of independent investigation of the reputation or credit rating of the prospective clients. It is quite usual to know a good deal about the reputation and standing of a client before he becomes a client; in connection with making arrangements with a new client, it is customary to receive considerable information concerning the client from various sources.

If such is not the case, we do make inquiry. Sometimes we obtain a Bishop's report concerning a client. Generally speaking, we like to feel satisfied as to reputation and credit rating of prospective clients before accepting an engagement. I do not mean to intimate that we always obtain conclusive information regarding the reputation and credit rating of a client before we accept an engagement. We do not go ahead with an engagement unless we feel the reputation of a client is such that we may reasonably rely on his integrity. I believe this feeling is shared by most public accountants since to a degree the auditor must feel that he is entitled to place a measure of reliance on representations made to him by a client.

Q. From your experience in public accounting, Mr. Lenhart, who would you say exercises the prerogative of appointing auditors to certify annual reports to stockholders if the corporation stock is publicly held?

A. I would say that the board of directors either actually appoints the auditors or acquiesces in their appointment. The appointment may apparently be made by one of the officers but I doubt whether such appointment would be made if the board of directors objected to the appointment or wanted another firm of public accountants.

Did you include in that the question about responsibility?

Q. Go ahead, if you will.

A. I would say that our primary responsibility is to the board of directors as representatives of the stockholders.

Q. When you accept an audit engagement, Mr. Lenhart, by what representative of your firm is the scope of the audit determined and do you reexamine it annually in case of a continuing audit?

A. When accepting an engagement a partner of the firm determines the scope of the work to be performed to attain whatever the objective may be; the scope of the audit is reexamined annually in the case of a continuing engagement.

We have an individual audit program for each engagement. At the top of this program there appears the following heading:

The following audit program covers the work to be performed under the conditions of the engagement existing at the date appearing on these programs. It is to be distinctly understood that this program does not necessarily include all work to be performed, nor does it exclude any further examination which may appear to be necessary. The program does not absolve any member of the staff from using all diligence in detecting errors or irregularities. Any items not covered by the program should be investigated but if it appears that such investigation will materially increase the time allotted to the engagement, the situation should be brought to the attention of a partner or manager so that the necessary approval may be given before the additional work is undertaken. Any necessary additions, eliminations, or revisions must be made in this program in ink at the end of each engagement.

This heading by the way has been used by us since 1927.

Q. From your experience who would you say decides such questions on the part of the client?

A. From my experience I would say that the client does not determine the scope of the audit. The client may determine the services he wishes rendered, but the auditor determines through its partner the scope of the work which should be performed to render such service.

Q. Looking to the future, do you think that there should be any change in the method of appointing auditors or of fixing the scope of the audit?

A. I think it would be desirable that there should always be formal selection of auditors by the board of directors. I do not think there should be any change in the practice of permitting the auditor to fix the scope of the audit because he should be able to determine what work he thinks should be done in order to accomplish whatever the objective may be.

Q. Would you say that it might be desirable to have the auditors appointed at the beginning of the year instead of at the close?

A. I would say so.

Q. What would be the advantages in that?

A. One advantage would be that it might be possible in more cases to do interim work through the year.

Q. Now, turning to your own firm, Mr. Lenhart, do you classify your personnel, for example, between seniors and juniors, et cetera?

A. We classify between partners, supervisors, seniors, semiseniors, and juniors.

Q. When an engagement is accepted, how do you determine what partner, seniors, et cetera, should work on a particular audit?

A. When an engagement is accepted, it is put in charge of either the partner who arranged for the work or some other partner. Usually the partner who arranges for the work looks after it in the future but if it involves some specialized line of work, it may be turned over to the partner who has most familiarity with that type of work. In any event, the partner who is in charge of the work determines with the man in charge of our personnel, the supervisor, seniors, semi-seniors, and juniors who are actually to work on the engagement.

Q. Do you attempt there to assign people to the audit who also have special experience in the particular type?

A. We do.

Q. Are these assignments permanent in the case of successive audits?

A. We make an effort to retain the same supervisor for successive audits. Usually we retain the principal men on the engagement for successive audits. We do not make any particular effort to retain juniors and semiseniors on an audit, and in fact we make some effort to shift semiseniors and juniors around in order to broaden their experience.

Q. What is your reason for following that policy? Let us limit it to the seniors and supervisors.

A. We feel that there is an immense advantage to be gained if you have competent top men, in having those men become familiar with the problems and with the details of a particular client's organization and there is a great deal of lost time and perhaps loss of efficiency in shifting top men.

As to any disadvantages in that policy, it seems to me that they must arise from a poor selection of supervisors or seniors. If a man is of the type who more or less shuts his eyes to what he sees or who grows careless through doing the same piece of work from year to year, I think he would probably be an unsatisfactory man on any engagement.

Q. Do you feel there is any advantage in changing, let us say, seniors and supervisors because of the possibility of getting a new point of view as to some of the problems?

A. I think theoretically there is, but actually there is so much discussion between the supervisor and perhaps other supervisors and various partners that I think that advantage is more or less unreal.

Q. Now, turning to the juniors on your staff, how do you recruit those both for your permanent and for your temporary staff?

A. For perhaps 12 or 14 years nearly all of the juniors taken on our permanent staff have been college graduates. Our temporary staff is made up each year largely from men who were with us the preceding year or who have been with us in years past.

The remainder of the temporary men are selected from those coming into our office to apply for a position, from employment agencies, and from the listings of the New York State Society.

Q. What training or experience do you look for in these men? Do you have any special requirements there?

A. We require a college education for juniors for our permanent staff. In such cases we attempt to select men with outstanding scholastic records, good personality, and other qualifications which we think might well fit them for advancement in the profession.



For the temporary staff we require either a reasonable amount of public accounting experience or a substantial amount of experience in private accounting work. We do not attempt to use temporary men other than as assistants with the possible exception of some few men who might have been on our permanent staff in past years and who, for one reason or another, are with us temporarily.

Q. Do you look in the college training for specialized work in accounting?

A. We not only look for it, we require that.

Q. Do you have any regular policy of transferring to your permanent staff men who come on the temporary staff?

A. We do not have any regular policy, but if we find we have an exceptional man on the temporary staff we might add him to the permanent staff.

Q. Now, in regard to the men you employ, that is, particularly the juniors, do you have any regular requirements as to further education, self education or training, do you require them to get a C. P. A. certificate?

A. When a junior joins our staff he goes through a course of teaching and training to which he devotes most of his time for some months; talks are given to these men by various members of the staff.

After the men start active work, the personnel manager and a partner receive a report from the senior or supervisor on every engagement on which the man may work. This report is addressed by the partner to the man in charge of an engagement. This report asks how the man in charge of the engagement would rate the junior or semisenior, whether he considers him as having any outstanding qualifications as to accounting ability, personality, handling of clients, etc., and whether he has any outstanding faults or lack of what would be considered necessary qualifications including appearance, habits, etc., and if so, whether any such suggestion can be made as to any particular action which might be taken toward assisting the man to make an improvement in or to entirely overcome such faults or lack of qualifications.

The partners do not actively participate in the training of juniors. One partner does follow up very closely the character of the training given and one partner does read every report received in the office concerning the qualifications and faults of every man on every engagement.

We suggest to the men various courses of reading or training which might help any faults which may have been developed through their work.

A C. P. A. certificate is not a requisite for advancement. However, any man who has sufficient interest in public accounting to make good progress is undoubtedly interested in securing a C. P. A. certificate.

From time to time we urge members of the staff who do not have C. P. A. certificates to make every effort to obtain them.

Q. Do you have any requirements as to possession of a C. P. A. certificate for the higher ranking members of the firm?

A. We require any man who might be made manager of an office to have a C. P. A. certificate, but other than that we do not have any requirements.

Q. Could you characterize or describe the duties which you customarily assign to juniors?

A. The duties or type of duties assigned to juniors are largely of a routine or clerical nature, are fully outlined by the semisenior or senior on the engagement and the juniors are closely supervised as to the work they do.

Q. Would you say that the work they do requires a knowledge of accounting?

A. Yes.

Q. Speaking generally, turning to the seniors for a moment, from what sources do you obtain the seniors?

A. Nearly all our seniors are men who started with us as juniors. There are some exceptions, largely men who have had their training with other firms and who either came with us on a temporary basis or who applied to us and were taken on our staff in years past.

Q. Can you describe or characterize briefly the type of duties assigned to seniors, skipping the semisenior class for a moment?

A. The seniors are actively in charge of field work under a supervisor. The duty of a senior would be to direct the activities of the juniors and semiseniors and to take up any question which may be raised by juniors or semiseniors, to see that the audit program is followed and to see that the work is brought to a conclusion as expeditiously as it can be.

Q. Would you characterize them as being in charge of the field work on the audit program, or does that fall to the supervisor?

A. We make every effort to have the supervisors actually supervise the work. There are two kinds of supervision. Under one plan the supervisor sits in the office and supervises by remote control, and in the other case he actually goes out to the client's office and exercises enough actual supervision to know that things are being done the way he wants. We make every effort to follow the latter course.

Q. To what extent do you consider it a part of a senior's or semisenior's duty to train the men under him, and how would he do that?

A. I consider it a part of any senior's general duties to train the men under him. He should direct their work, explain why certain things are done, explain why certain omissions or faults of the juniors or semiseniors might be detrimental to the work, and should report to the office anything he thinks might be done to assist in the education and advancement of juniors and semiseniors.

Q. What part do the partners in your firm play in the audit program, Mr. Lenhart; do they actually participate in the field work to any extent?

A. Yes; the partners do, although the extent to which they participate varies. We have a policy in our office that we must have an individual audit program for every engagement. That audit program must be approved by a partner, and if it is not, the working papers relating to an engagement cannot be accepted by the file room. That automatically forces the matter to the attention of a partner and he then has an opportunity of reviewing the audit program.

In the cases of most engagements the partner would call on the client and discuss the work at least once during an engagement. In some cases the partner may call there 10 or 15 times. In other cases the partner may have had so much contact with the work in the past and may be so familiar with the problems that he might not appear at all during the course of the engagement, although he would be apt to call on the client during the year.

Q. When the partner goes down to the client, does he see any person in particular, or is it a general visit to see who is there, et cetera?

A. That depends. We rarely merely call on a client just to call. If there is some matter that the client wishes to talk over, we of course go down to talk over the matter with him. If something comes to our attention which we believe is of interest to that client, we would be quite apt to either call on him or possibly arrange to have lunch with him to discuss the matter.

Q. Does the partner when he goes down to the client's place of business review any of the audit work that is then in progress, consult with members of his staff, et cetera?

A. Yes, although the extent to which that is done varies tremendously.

Q. Would you characterize it as more or less of a casual supervision?

A. No; I would not. I think the extent to which that is done depends upon how intricate the particular engagement may be. It also depends upon the ability of the supervisor in charge of the engagement. It depends also upon the sense which a partner may develop as to those things which he probably should pay more attention to than others, those things concerning which he thinks the supervisor might not have reached as good a judgment on as the partner might have reached.

Q. Now, in a new engagement, do you expect the staff assigned to become generally familiar with the trade or industry in which the client is engaged?

A. We do.

Q. Do you expect your juniors to be sufficiently familiar with the type of records and documents with which they will come in contact to be able to recognize significant irregularities, for example, the absence of a date or signature on a check or endorsement?

A. We do expect them to be able to recognize any significant irregularities.

Q. How do they obtain that ability?

A. Such training and knowledge is gained first by their college training; second, by the training they get in our office before being assigned to an engagement; third, the instruction, advice, and training that the men receive on engagements; and, lastly, through the various and many bulletins, letters, et cetera, which the firm issues from time to time to the staff.

Q. And that advice on the job you refer there to the supervision of the senior?

A. I do.

Q. Do you expect your staff to be alert to note and report any irregularities they may observe?

A. We certainly do.

Q. What instructions do you give the staff as to what should be done when the irregularity is discovered—take it up with their own superiors, go to the client, or what is the procedure?

A. We expect members of the staff such as juniors or semiseniors to report any irregularities to their immediate superior. The senior would be apt to take the matter up with a partner if he considers it to be a matter of sufficient importance.

If the matter appears to be of immediate importance, the partner may take the matter up with the client or ask the senior to do so. If it is not, it may be included in a letter to the client containing any suggestions we may have as to the client's internal organization, system of internal check and control, et cetera.

The position we would take in any such case would depend entirely upon what sort of irregularity it was.

If it was a case of defalcation or suspicion of defalcation we would certainly take it up with the client as soon as possible. If it was something that had to do with form of organization or improvement in procedure, we would be apt to wait until the examination was over.

Q. Would you simply present the evidence which your audit disclosed, or would you pursue the investigation yourself and attempt to get a pretty full picture before you went to the client?

A. There again it would depend upon the nature of the matter. It has always been our policy, and I think it is the policy of most firms, after they once undertake an engagement, no matter what the fee arrangement may be, they are in a position where they must do whatever amount of work they feel is necessary to complete the engagement to their satisfaction.

Q. You would say, then, it might depend upon the significance of the irregularity?

A. Entirely.

#### IV. CONDUCT OF THE EXAMINATION

##### A. INTERNAL CHECK AND CONTROL

Q. Now, turning to the system of internal check and control, to what extent do you require the members of the staff assigned to an engagement to become familiar with the particular concern being audited, that is, its plant layout or its operating methods, nature of the products, method of selling, distribution, purchasing, and so forth?

A. We expect the members of the staff, particularly the supervisors and seniors, to be familiar with the system in effect.

Q. What do you mean by system? You are referring to the accounting?

A. Both to the organization, the accounting records, the form of internal check and control, the products made by the company, location of plant, and such matters as that.

Q. And methods of doing business?

A. Yes.

Q. Do you obtain an organization chart or its equivalent indicating the duties and lines of control or supervision, so far as the accounting procedures go?

A. We either obtain such a chart or its equivalent, or if the client has a comprehensive chart, we may make sufficient notes without actually obtaining a copy of it.

Q. But you would have something that would indicate those things?

A. We would.

Q. What do you understand this term "system of internal check and control" to mean?

A. I understand the term "internal check and control" to mean the segregation of duties to minimize errors and chances of defalcation. The basic feature of a good system of internal check and control is that two or more persons must be involved in order for there to be any material error or fraud. Its purpose is to safeguard the assets of a company and to insure the accuracy and integrity of its accounts. A satisfactory system of internal check and control cannot be used unless there is a sufficiently large personnel for adequate segregation of duties.

Q. How would you distinguish the phrase "system of internal audit" from this system of internal check and control?

A. A system of internal audit is the system of checking the work done by others, whereas a system of internal check and control concerns itself with the original work of handling and recording the daily transactions.

Q. Then you say that a system of internal audit might be one of the features of a system of internal check and control, is a supervision of it?

A. I would think so. It is certainly a part of the control, if not of check.

Q. On page 7 of this bulletin it is indicated that the nature and extent of the examination depends upon the purpose of the examination and the amount of detail to be included in the statements covered by the report, the type of business, the accounts which are to be examined, and the system of internal check and control. Could you explain briefly the effect of each of these factors on the scope of the examination?

A. An examination for the purpose of a financing would require much more work than an examination for an annual report. A statement grouping all expense accounts in one item would involve much less audit work to assure the auditor as to the integrity of the total than would be necessary if he is to assure himself or be satisfied of the integrity of the totals of each of 10 expense classifications.

A business with a variety of assets and a large number of transactions would normally require a more extended examination than one having only a few assets of a certain aggregate amount and only a few large transactions also of the same aggregate amount.

The better the system of internal check and control the more the reliance that can be placed thereon with the consequent reduction in the necessary examination.

Q. Would you say regarding the type and size of a business, that the relative significance of the various component assets might indicate the type of examination or cause a more extensive examination in certain parts than in others?

A. I would think that many factors might be involved; both the number and size of assets, the number and size of the transactions during the year, and the number of employees, would have some bearing.

Q. I think perhaps you misunderstood my question there. Referring to what you have said in the previous one, would you think that the scope of examination would have to be adjusted to provide a fuller examination of the more important assets in a particular case as compared to another case in which those assets were less significant?

A. Yes.

Q. For example, compare an investment trust and a utility.

A. Certainly; in the case of an investment trust we feel that we must make a detailed audit to really be able to express an opinion. I think that the relative size of assets has a great deal to do with any examination. In one case the inventories may be quite small.

Q. Such as a utility, for example?

A. Yes; while in other cases they may be the most important item in the whole balance sheet.

Q. I think you indicated a moment ago that there are a number of things that determine what is the relative size, for the purpose of an examination. Am I correct that you feel that there is no single criterion of these various factors, such as number of assets, etc.?

A. I think, as to the question of whether you make the type of examination in section 2 or in section 3, the most important factor is the number of employees, and the question of whether there is a satisfactory separation of functions and duties. I think that a company with a relatively small dollar amount of assets and small dollar amount of volume might still be in such type of business that you could have a satisfactory segregation.

Q. Now, at page 9 in the bulletin, it is indicated that the extent of the examination is to be based in part on the accountant's knowledge of the individual situation. What is your understanding, Mr. Lenhart, as to the extent of the knowledge of the individual situation which an accountant should have before completing his first examination?

A. I think the accountant should have a reasonably comprehensive knowledge of the client's business, his accounts, his supporting records, and his system of internal check and control.

Q. What procedure do you use in developing that information?

A. The procedure we use largely consists of inquiry and observation. From time to time we issue bulletins to our staff indicating the general features we believe should be covered in any such inquiry. The last bulletin we issued on this subject was dated September 1938, and covered 12 pages.

We do not insist on reviewing every item of internal check and control every year. We do insist that more important items be reviewed each year.

Q. Do you utilize a questionnaire of any sort in this connection?

A. We do not.

Q. Do you have a permanent file with respect to an engagement?

A. We do have.

Q. Do you require that there be included in that some description of the system of internal check and control, for example, that you have found?

A. We require that there be such a description in the permanent file.

Q. And as to significant items, that description is reexamined in the course of each audit?

A. It is.

Q. But not as to minor details or not as to all minor details, I should say?

A. We try to examine those things which we believe might be of vital importance each year. Then there are other items of importance which are examined perhaps every 2 or 3 years.

Q. Now, does that memorandum also cover the question of whether the system of internal check and control purported to be in use is actually being followed?

A. By memorandum, do you mean the one in our permanent file?

Q. Yes.

A. I don't know that the memorandum itself does that, because the memorandum is supposed to be the result of actual observation of what is in effect.

Q. How would you go about ascertaining whether the principles of that memorandum were still being followed?

A. We would base our determination not only upon statements made to us as to what the accounting procedures and system of check and control might be, but we would contact those performing the various duties. We have generally found it unsatisfactory to rely upon an outline given to us by one or more administrative officials.

Q. When you say those performing the duties, do you mean the ones who actually do the work?

A. I do. We feel that if we don't actually observe the work done by the various individuals, we are apt to get an outline of what the system should be rather than what it actually is.

Q. In your examination of various records of the company such as, for example, sales returns, do you find any evidence there as to whether the system is being followed, such as, for example, initials of the person who should initial it, etc.?

A. Yes; we do look for that.

Q. Now, if weaknesses are found in the accounting and control procedures, Mr. Lenhart, do you feel that these might require additional steps in the audit program? Will you give some illustrations, if you can?

A. If weaknesses are found in the accounting and control procedures they may or may not require additional steps in the audit program, depending on the nature of the weaknesses found. If we should find that one man has access to both cash receipts and cash disbursements and perhaps to accounts receivable records, we would certainly insist upon doing much more in the way of verification of cash details and of accounts receivable than would be the case if an adequate system of internal check and control was in effect.

The additional work might be discussed with the company. If such work is justified, I would not expect the company to offer any objection to such work.

Q. And if it did?

A. If the work is justified I would not expect it.

Q. And if the company did under such circumstances object, what would your position be?

A. Then I think the company would have the choice of our withdrawing or changing its mind and letting us do the work.

Q. When one of these weaknesses is uncovered, do you expect that consideration shall be given as to whether additional audit steps are necessary?

A. Yes; consideration should always be given as to whether additional steps—

Q. And on the basis of that you would decide whether to do anything further?

A. We would.

Q. Would you say that the check-up on the system of internal check and control which you make should result in a thorough knowledge on the part of the auditor of the accounting system followed by the client, including a knowledge as to what documents, records, and other evidence accompanied the transactions, the various steps in the accounting procedure?

A. Well, I would say that our examination of the system of internal check and control should result in a fair knowledge on the part of the auditor of the accounting system followed by the client and a reasonable knowledge of each document, voucher, and other paper used to support each step in the procedure.

On the other hand, I do not believe it essential that an adequate review of the system of internal check and control would necessarily include familiarity with the minutest detail of each document, voucher, or other paper used to support every step in the procedure.

Q. Do you mean to imply that all of those documents are examined each year?

A. I do not.

Q. But that is representative—that is not requiring a complete examination each year, but such documents as you do examine you would check up on your system of internal control as you saw it?

A. Yes; we would.

Q. And do you feel that an examination in accordance with this pamphlet, or your own examination, should detect fraud, Mr. Lenhart, and in that connection you might refer to the sentence on page 10 of the bulletin. That's the second full paragraph, the second sentence.

A. I would not feel that an examination in accordance with the pamphlet will necessarily disclose fraud. I believe on page 10, paragraph 2, means that, short of a detailed audit or examination, defalcations will not necessarily be disclosed nor every understatement of assets concealed in the records of operating transactions or by manipulation of the accounts, for the reason that such defalcations, understatements or manipulations may be reflected in that part of the records which have not been examined by the auditor.

I believe the auditor should feel satisfied as to the general integrity and accuracy of the records. I do not believe he need necessarily feel that they are strictly accurate in the sense that expense classifications are correct to the last detail.

Q. Do you attach any significance in that sentence to the use of the phrase, "understatements" instead of overstatements, or is that compared to defalcations?



A. I attached a great deal of significance to that part of the sentence. It has been my feeling that you may be fully satisfied as to a balance sheet both at the beginning and end of the year, and you may be pretty well satisfied as to the income account. You are more apt to find overstatements of assets than understatements. I think a great deal of what's regarded as good accounting procedure is being gradually whittled away to a little more conservative viewpoint. Some things of 10 years ago which would have been regarded as items which should be capitalized or carried along are not quite so much so regarded today.

Q. Now, within the scope of the examination that you do make, that includes the examination of such records as are called for in the audit, would you say that the auditor should be alert to detect fraud and irregularities?

A. He should be.

Q. Now, speaking generally, what is your practice as to making test examinations of the records covering certain types of transactions such as sales, plant additions, cash disbursements, purchase returns and things of that sort? Do you make a sampling of those?

A. In cases of most engagements we do make tests or samplings rather than detailed audits.

Q. Do you feel that such tests, if the results are satisfactory, adequately verify the records, as a whole?

A. Why, I see no conceivable way in which tests could either conclusively or inconclusively verify the records. I think the tests merely lead an auditor to place reliance upon the records and have belief in their integrity and to feel that he may rely thereon.

Q. Do you feel that those samples are sufficient to do that? I mean, the sampling process is sufficient to do that?

A. I believe the sampling process, coupled with the scope of selection of how many transactions should be sampled and coupled with the knowledge of the internal check and control is sufficient to do that.

Mr. WERTZ. I wonder if we might have a few minutes' recess.

The EXAMINER. Yes.

(Thereupon a short recess was taken.)

#### AFTER RECESS

##### B. CASH

Q. (By Mr. WERTZ.) Now, Mr. Lenhart, coming to some of the details of the audit program, taking cash first. Do you consider the cash program which is outlined on pages 11 and 12 of the bulletin as a minimum or maximum procedure in your own practice, and would you indicate anything you add to it or leave out customarily?

A. Well, in our New York office in addition to the steps outlined, we customarily make a second bank reconciliation and a comparison of details of deposit slips for a few days before and after the balance sheet date with the corresponding cash-book entries.

Neither of these procedures is invariably followed by us, but they are followed in most cases.

Q. At page 33 of the bulletin there is a reference to reconciliation of bank accounts by employees independent of the cashier's department. How important do you consider such a matter?

A. I consider it of very great importance in any satisfactory system of internal check and control.

Q. Would your answer be equally applicable in the case of small working funds as it would be to the large general funds?

A. As a matter of good control, I would say it would be.

Q. Do you reconcile all of the bank accounts yourself, including the working funds?

A. I can't recall a case in which we do not reconcile all of the principal funds. There may be small funds in outlying points that we do not visit, and in those cases we are quite apt to ask for, and receive, a certificate from the custodian of that fund. We would only do that if the amount was quite small.

Q. I see. Now, referring again to item 8 on page 12 to this sentence as to the comparison of original deposit slips with the cash book, and so forth, you indicated that in those cases you did that and in some cases you did not. Did you have any particular circumstances distinguishing the two there?

A. When we are examining the accounts of a company which has an exceptionally good system of internal check and control, particularly if the company is very large and has a great number of bank accounts, we might not make such a check of details.

Also, we have to consider the present practice of many banks which use the so-called "block system" in which the bank never makes any efforts to check the details of the deposit slips against the amounts actually deposited unless there is some error developed.

In the usual case, however, we do make some of these tests and we generally find enough in the way of defalcation in that way to make it a continued practice.

Q. Could you indicate briefly what effect this "block system" has on the practicability of making such a test?

A. Well, in 3 or 4 deposits made, there may be a slip with 100 items, and with the 100 items, checks or whatever they may be. The bank will run a tape on all of the items, and if the total of that tape equals the total of the various deposit slips, the bank is satisfied.

Now, there may only be 50 items handed in as compared with the 100 items listed on the deposit slip, but that would not cause the bank to question the items at all—question the deposit slip at all.

Q. How would that prevent you from making such a test here?

A. It would not prevent us from making such a test, but it would make the deposit slip quite unreliable. If the man who was stealing money knew that the bank used the block system, he would be quite apt to make a correct listing on his deposit slip even though that listing did not agree with the amounts he was actually depositing.

Q. I see.

The EXAMINER. You mean by that he might deposit one check for a thousand dollars, and that would cover four or five items on his deposit slip?

The WITNESS. Either that or he might be lapping assets and deposits. There may be 11 items, each one differing in amounts from each one on the deposit slip.

Q. (By Mr. WERNITZ.) Is the block system in wide use today, do you know?

A. Yes.

Q. Now, in the third line of item 8 on page 12, what do you understand to be meant by the term "bona fide receipts," and how do you establish that they are bona fide?

A. Well, in my opinion bona fide means genuine. The bona fides of such receipts are established by checking details against deposit slips, checking details to customers' accounts, and checking bank transfers to make sure that amounts deposited in one bank are recorded as withdrawals from another bank, etc.

Q. Does that bona fide, then, mean merely apparently genuine from looking at the documents, or does it involve the determination of whether the documents, checks and so forth, are, in fact, genuine?

A. Well, I think what it attempts to establish is that the items listed, so far as we can find, are actually the amounts which were received and which were deposited.

Q. Is it customary and proper, in your opinion, Mr. Lenhart, to include in cash, amounts due from foreign banks and from private bankers?

A. It is customary and proper, if such funds are unrestricted and are subject to immediate withdrawal. I do not believe it is customary or proper to include such amounts in cash if they do not represent unrestricted funds immediately available upon demand.

Q. How do you determine the existence of restrictions or their absence?

A. We customarily determine the existence or absence of such conditions by inquiry or by such knowledge as we may have of conditions in foreign countries and by ascertaining the conditions of deposits in case of any private bankers.

Q. Is that problem, specifically considered with respect to each case of a deposit in a foreign country, so that if you don't have the knowledge you do inquire?

A. We would then make enough inquiry to find out the actual conditions.

Q. Do you have any procedure which you follow to establish that if a particular item is, in fact, a bank or private banker?

A. We do not have any established procedure to establish that any particular depository is a bank or a banker. In the majority of cases we know the institutions in which the items are carried. The review of transfers between a depository and bank with which we are not familiar and the receipt of statements, canceled checks, etc., would help establish the fact that a particular depository is, in fact, a bank.

Q. Do you make any other tests or inquiry?

A. We do not customarily make any other tests; no, sir.

#### C. ACCOUNTS AND NOTES RECEIVABLE

Q. Now, turning to accounts and notes receivable, Mr. Lenhart. In several places under the instructions with regard to those, particularly items 3, 5, and 6, the pamphlet indicates the necessity of making inquiries as to particular methods. Could you describe briefly how and from what person or persons the necessary information is customarily obtained?

A. Well, that information is customarily obtained from such officers or employees as are most familiar with the particular matters

concerning which inquiry is made. In the case of accounts receivable, it is apt to be the credit man.

Q. Is there any attempt to check one person against another, or do you rely upon the individual concern?

A. Well, whenever possible, if we thought that two men knew something about the accounts, we would be quite apt to ask both men independently of each other.

Q. Now, item 3, the first sentence reads: "Examine the composition of outstanding balances." What do you feel that means?

A. Well, I understand that to mean that the auditor should ascertain whether the balances represent current charges or past due, and if past due, for how long past due.

Q. How would you go about determining that?

A. We would either analyze the accounts ourselves, or arrange in advance for the client to analyze the accounts, and we would then check the analysis made by the client, or else make our own analysis from the accounts receivable ledger.

We would note any apparent payment of later invoices, or failure to pay earlier ones, which might indicate there is some dispute as to the amount of the account.

Q. To determine that, how far back into the accounts would you go?

A. We would be quite apt to go back to the date of our previous audit.

Q. Or in the case of a first audit?

A. In the case of a first audit I think we would go back to a date far enough so that we feel that the balances beyond that date were pretty much worthless or should be 100 percent reserved for.

Q. Now, do you expect the general conditions of accounts receivable to be noted such as the concentration of charges at the year-end or in any particular month, the presence or absence of special credits for write-offs, returns, allowances, claims and so forth?

A. I would expect all of those things to be noted and, as a matter of fact, we not infrequently come across cases where accounts receivable have been built up at the end of a period to make a good showing on the part of some one.

Q. Now, at the top of page 15, there is a sentence which reads as follows:

Referring to the confirmation of receivables, 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.

Is it your understanding that this sentence implies that receivables ordinarily should be confirmed?

A. Well, I believe that sentence merely implies the desirability of confirming receivables. The Federal Reserve Bulletin published in 1917 contained a sentence reading:

The best verification of an open balance is a confirmation by the customer; therefore, if time permits and the client does not object, it is advisable to circularize the customers.

Apparently at that time the client's objection was much more serious than it is now.

In times past many clients objected to such confirmation. Over the course of the last 10 years, we have made at least test confirmations in an increasing number. I believe that test confirmations are always desirable, not only for the purpose of confirming the amounts of the balances, but also for the purpose of indicating to the auditor whether the system of internal check and control is working satisfactorily.

It seems to me that you may review the system of internal check and control and observe how it is working, but the best test is whether that internal check and control actually results in accurate accounts receivable balances; that I do think you find out by test confirmations.

Q. Would there be special circumstances under which confirmation of accounts receivable would be particular and desirable, such as the concentration of large balances in a few, or relatively few, accounts?

A. I think there would be. Also if there is an apparent increase in charges late in the year, it may well be that goods are either shipped out or not included in the inventory, but charged to a customer, whereas the customer might not agree that he had any liability whatever for those goods.

Q. Does the past credit and adjustment record of individual accounts affect the desirability or necessity of confirmations, in your opinion?

A. I think a test confirmation is desirable in any event. However, if an account has been collected prior to completion of the audit, or if the credit or adjustment record of the individual account had been entirely satisfactory in the past, I believe it might be more sensible to confirm accounts which had not been paid or which do not have such satisfactory records, rather than those which have been paid or which do have satisfactory past records.

In that connection, the fact that we make a second bank reconciliation enables us to feel more assurance that payments recorded are actually payments received, and I don't think we are in a position so much of relying merely on a book record of payments having been received.

Q. In the absence of a second confirmation, how would you feel about that point?

A. Second bank reconciliation?

Q. Second bank reconciliation. Excuse me.

A. I would feel that we could not be too reliant upon a mere book record of cash having been received without going a little further in assuring ourselves that cash actually was received and was deposited in the bank.

Q. Now, when you were mentioning the desirability of confirming those balances which had an unsatisfactory credit or adjustment record, do you imply there that you might not have to make any confirmations, or is that simply a method of selecting which methods to confirm?

A. Well, I would say that it would depend entirely upon conditions, whether we feel we could refrain from sending out any confirmations whatever. If I were making a selection, I think I would be guided in my selection by two things; one, trying to get as large a dollar

volume with as few confirmations as I thought I had to send out, and I would also try to confirm those accounts which I might feel to be more apt to be out of balance with the client's records.

Q. Now, coming to these various methods of making confirmations. There are three that have received some notice, a positive confirmation of as many as possible, a positive sample confirmation of possibly the largest in dollar volume plus any sampling of the smaller accounts and, finally, a negative confirmation of all accounts.

How do you feel as to the relative value of those tests, having in mind also the cost?

A. Well, I think the negative type of confirmation is much to be preferred whether it is used merely as a test or with respect to all accounts. The difficulty I find with the positive type of confirmation is that if the auditor mails out positive confirmations with respect to all the accounts and receives replies with regard to 60 percent thereof, he is then in the position of deciding whether it is safe for him to render an opinion with regard to the financial statements knowing that although a specific request for reply has been made with respect to the 40 percent unconfirmed and perhaps the second request has been made, no such reply has been received.

As a definite indication of the customer's agreement as to the balance there is no question but that the positive type of confirmation is more informing than mere failure to receive a reply to a negative confirmation.

At the same time I see no reason why the auditor must saddle himself with the problem of deciding whether it is safe to proceed without having a definite reply from all customers.

If the customer's address is fictitious, the auditor should receive his negative confirmation request back from the post office which would put him on notice as to something being wrong; if the account is fictitious and there is someone at the address to receive the affirmative confirmation request, there is no doubt but that the auditor will receive a satisfactory signed confirmation of the amount stated to be due.

Many companies today do not concentrate their accounts payable records in one place and are therefore unable to answer any confirmation requests. It is notoriously difficult to secure confirmation records from governmental bodies.

I think that except as to brokerage or Wall Street examinations, the negative type of confirmation should be generally used rather than the positive type. I think that if the negative type of confirmation is used, it should indicate that in the absence of any reply being received, the auditor will consider the accounts as in agreement with the customer's records. It is sufficiently good type to use so that he can rely on failure to receive replies to such confirmations. I am in some doubt as to just what is going to happen some day if an accountant sends out confirmations regarding accounts receivable of \$1,000,000 and doesn't get replies concerning 400,000 and certifies the statement and then later it develops that 250,000 of those accounts didn't exist. He must then explain how in the world he could certify with somewhat positive knowledge that there might be something wrong.

The practical answer, of course, is to send out the positive type and it might be then 10 months or a year before you can certify, which also involves some tactical difficulty.

Q. You mentioned the fact that it is customary not to have accounts payable grouped on the books by many companies. Would it be possible under such circumstances to confirm, say, the last three invoices?

A. That might be done.

Q. Do you think that that might serve as a possible method of confirming the balance?

A. Well, I would doubt whether that would confirm the balance.

Q. Well, isn't it true where they do not concentrate accounts payable they customarily pay them when they come due?

A. They do.

Q. And, therefore, there would not be much of a balance except for the last two or three?

A. That's right.

Q. Under those circumstances couldn't you use this other type?

A. I think you might well do that if the auditor could determine that the balances represent certain specific invoices and then confirm the fact that those invoices had not been paid at the balance sheet date, I think that would serve just the same purpose.

Q. That is, by labeling the confirmation with respect to the particular invoice numbers it would overcome nonconcentration in a single account, perhaps?

A. We have used another type of confirmation in between these two types and in those cases the client sends a letter which is in the negative form but which includes requests for the customer to confirm any of them in order that there may be some knowledge on the part of both the customer and the client that their records are in agreement.

Q. Now, at page 8 and again at page 34, under "Accounts receivable," reference is made to safeguards surrounding the handling of incoming mail, remittances, and to the mailing of monthly statements to customers. What inquiries do you make in this connection and what steps do you take to assure yourself that statements are actually being mailed to customers?

A. Well, we not only inquire into, but we observe the method of handling incoming mail and remittances and the mailing of monthly statements to customers. I do believe the mailing out of monthly statements by someone other than the employees working on the customers' ledger with provisions for replies to come to someone other than the employees working on customers' ledgers is a partial assurance that the accounts are authentic. I think it is highly important not only to find out that perhaps that incoming mail and remittances are received in a mail room and lists made, but also it is important to find out just what happens to those lists afterwards. I recently had a case in which complete lists were made of all incoming remittances and those lists were turned over to a party other than the one who kept the books and received the cash. I found that when any discrepancy was developed, the list was turned over to the person who was stealing the money and was returned with the explanation that it had been checked back and found all right.

Q. When you say "observe," what do you have in mind there? Do you observe the opening of the mail and so forth?

A. Yes; I would actually see how they handle the incoming mail, how they make their lists. I would see what methods were followed in the handling of those lists after they were made and I would talk to whoever receives them and find out just what is done and how they do it in checking those lists against the list of receipts.

Q. And as to outgoing mail?

A. As to outgoing mail, I would want to see the actual procedure followed. You, no doubt, are familiar with the case that developed in Philadelphia where statements were mailed by someone other than the person who was stealing large amounts and a little observation there would have disclosed that the mailing consisted of putting them in a mail basket in the office from which the party who was stealing would extract those that he wanted to take out.

Q. Now, on page 34 of the bulletin. What kind of examination do you understand is meant by the term "relatively limited tests"?

A. I would think that means a small percentage, 10, 15, or 20 percent.

Q. And what sort of a test would that be? What would you do on that 15 or 20 percent?

A. That is on page—

Q. Page 34 under "Accounts receivable," the fourth and fifth lines.

A. Well, I think I would still do the same thing as if I were making a more extended test, except I would confine it to a small cross-section or percentage of the accounts. I would probably mail out some confirmations, would check the aging of some of the accounts, would make whatever tests I would ordinarily make, except I would restrict it to a few accounts rather than a great number.

Q. That's what I had in mind, the characterization of the type of test. If you determine that it is unnecessary in a particular case to make confirmation of open accounts, would that control your decision as to confirming notes receivable which grew out of open accounts?

A. I do not think there is necessarily any reason why the decision with respect to accounts receivable confirmations would control the decision with respect to notes receivable. I think much would depend upon the type of business transactions giving rise to the notes, the amount of the notes, their availability for inspection, the possibility of payments having been received without having been properly recorded, and any other factors of that kind. I see no connection whatever between the two merely because the notes grew out of the accounts.

Q. At the bottom of page 33 it is stated that:

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

Could you indicate whether you feel it would be desirable to confirm, in such a case, and also what the outstanding features of an internal check would be?

A. I would consider it desirable but not particularly necessary to confirm the notes receivable if there is a satisfactory system of internal check and control.