

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, March 7, 1939.

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

PROCEEDINGS

The EXAMINER. Will you be sworn, sir?
Whereupon:

JOSEPH J. KLEIN

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 please give the reporter your full name and address?

The WITNESS. Joseph J. Klein, 19 West Forty-fourth Street, New York City, N. Y.

The EXAMINER. Mr. Klein, at this time I would remind you of your 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.

The WITNESS. The record might show that I waive them voluntarily and won't avail myself of them.

I. AFFILIATIONS AND BACKGROUND

Q. (By Mr. WERTZ.) Dr. Klein, will you state your present firm affiliation?

A. I am a senior member of the firm of Klein, Hinds, and Finke and I was a partner in the predecessor concern, all told, for a period of approximately 25 years.

Q. How long have you been engaged in accounting work and what has been the nature of it?

A. Prior to my affiliation with the present firm or its predecessors I did some bookkeeping work. For a short while I worked for another public accountant. This was both during school years and immediately thereafter.

Q. Had you had any educational training in accounting prior to that?

A. Yes, I had two courses in bookkeeping. I had no university work in accounting because, when I entered New York University, the authorities thought that, perhaps wrongly, there was nothing left to offer so I did work in economics and allied fields.

Q. Are you a certified public accountant?

A. I am in New York.

Q. Would you indicate briefly the size of your present firm, the character of it?

A. At the peak season we seldom go above a force of 100. The average in the last few years has not been under 50.

Q. The number of partners?

A. There are six partners all told.

Q. Could you indicate the principal types of clients served or the type of business you are principally engaged in?

A. Your letter which accompanied what seemed like these thousand more or less questions suggested that partners might assist, so Mr. Finke prepared this memorandum which indicates that our practice is more varied than I thought it was without thinking about it.

The services rendered include some or all of the following:

Auditing, systems installation, budgeting, cost studies, tax work, special investigations, services in connection with mergers, consolidations, liquidations, and reorganizations and, among the types of clients served, are the following: Agricultural products; cotton, wool, and silk mills, converters and distributors; wineries and liquor distillers and distributors; moving-picture producers, distributors, exhibitors; broadcasting; tobacco growers, jobbers and manufacturers of cigars; leather tanners and distributors; bag and luggage manufacturers; shoe manufacturers; shoe chains; banks, financial institutions, financiers and capitalists; Federal home-loan institutions; hotels and restaurants—

Q. I think that indicates—

A. (Continuing:)

And perhaps some 50 other types, including one I ought to give you, cemeteries.

Q. Those are fixed assets?

A. I should say they are not liquid.

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

A. Yes; I am a member of the New York State Society of Certified Public Accountants, I am a member of the American Institute of Accountants and of its council—governing board; I was a member of the American Society of Certified Public Accountants. I am a member of the National Association of Cost Accountants.

Q. Have you been active in committee work in furtherance of professional interests in those societies?

A. I have, throughout the years.

Q. Are you presently on any of their committees?

A. I am.

Q. Could you name one or two of those, just to indicate—

A. I am chairman of the tax committee of the New York State Society, I am a member of the committee on cooperation with bankers and credit grantors. I suppose three or four or five other committees.

Q. Have you published any works on accounting or any editorial work of that sort?

A. I have written probably more than I should have. I am the author of some textbooks on accounting and bookkeeping. I am

coauthor of a book on methods in commercial education, author of a text on Income Taxation, former tax editor of the New York Globe; my articles were syndicated in a group of newspapers.

I have written for magazines, technical and popular, and feature articles in newspapers, and so on.

Q. Have you been active in teaching accounting?

A. Yes. I helped organize the business courses at the College of the City of New York. I lectured on accounting and auditing, some economic subjects, taxation. For awhile I tried to teach teachers how to teach. I lectured occasionally at some other educational institutions.

II. SCOPE OF EXAMINATION OF FINANCIAL STATEMENTS

Q. Now, Mr. Klein, would you indicate and characterize the types of accounting services rendered by public accountants which lead up to or result in certification of financial statements?

A. I suppose there are two major divisions of the type of service to which you have referred: (a) Examinations of financial statements which lead to a certificate and then (b) special investigations for examinations which result in reports and may or may not result in a certificate as well.

Q. Would those special investigations be of the nature of a more detailed audit than the general examination you have referred to?

A. In scope it might be that, but also very frequently a detailed examination, within what I might describe as a narrow segment of the enterprise.

Q. In those cases would there be a certified statement resulting?

A. Usually no.

Q. And if there were the detailed examination of a special field, would that be accompanied by a general examination of the remaining part of the business in order to lead up to certification?

A. That might be true.

Q. Which type of these services do you customarily render in connection with annual reports to stockholders or statements filed under the 1933 and 1934 Acts?

A. The first, examination of financial statements. In connection with those second statements, in addition there must be performed services which enable the accountant to answer the specific questions which are—which require an answer.

Q. Are you familiar with Commission's exhibit 117 which is the bulletin on "Examination of the Financial Statements" that has been prepared and published by the American Institute of Accountants?

A. Reasonably so.

Q. Did you, or other members of your firm participate in the preparation of this bulletin?

A. No, sir. It is quite probable, though I have no present recollection of it, that my firm, in common with others, was asked to respond to questionnaires. If that were done, we would respond, because we always do.

Q. But you have had no direct participation in it, you might say?

A. I disown all responsibility for this bulletin so far as any participation in its preparation goes.

Q. In your opinion, Mr. Klein, what was the purpose of publishing such a bulletin?

A. You know, of course, there were two predecessor bulletins?

Q. Yes.

A. In each of these bulletins there is a brief statement indicating the purpose which motivated its preparation. I have no doubt, and I base this statement on a vague recollection, that the initial purpose was to attempt to inform the reader of the accountant's statement of the necessary limitations on the scope and extent of the examination, because throughout the years there has been misconception by the readers as to what the accountant had done and what his certificate means.

Q. Among the types of services—

A. May I add?

Q. If you will.

A. Latterly, the impression has become quite general that this bulletin is a sort of syllabus or outline of suggested steps to be taken in examination procedure.

Q. Among the types of services rendered by your firm which you described a moment ago, how would you classify the examination contemplated by this bulletin?

A. The examination of financial statements annually or at more frequent intervals.

Q. In such examinations do you feel that the underlying principles of the bulletin are of general application irrespective of the size or type of business?

A. You refer to principles?

Q. Yes.

A. May I point out there is quite a complete absence or lack of principles enunciated in the bulletin? I should say that the bulletin deals with procedural steps rather than with principles of accounting.

Q. I was speaking of principles of auditing rather than principles of accounting.

A. Bearing in mind what was already stated that this pamphlet is a syllabus or outline, and that all available texts on auditing and accounting combined cannot possibly supplant the exercise of discretion and sound judgment by the independent public accountant engaged in his professional work, I would say that, by and large, the suggestions contained in the bulletin are of general application to the examination of financial statements regardless of the size of the organization.

Naturally the bulletin deals with only the more usual types of businesses.

Q. In your own practice do you utilize or follow this bulletin as a general guide in examinations of the type contemplated?

A. The categorical answer would be "Yes," as a very, very general guide. The fact is that our own procedure independently developed through our own experience coincides to a great extent with the general scheme of suggestions set forth in the bulletin. I think that is true of many other accounting firms.

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

A. I cannot say that that is a precise requirement but all of our men are familiar with the bulletin, I believe, and probably most, if

not all of them, own copies. There is a sufficient number in the office for general use.

Members of the staff are frequently referred to it as they are to texts on technical subjects. I know that quite a few members of the staff carry their bulletins with them in their portfolios. One of my partners in his lectures on accounting urges his students to obtain copies of the bulletin.

Q. Looking at the bulletin generally, do you regard the auditing procedures or steps prescribed as a minimum or maximum in this type of examination?

A. In some respects the suggestions are comprehensive. That is true, for example, of the steps in connection with inventory testing and checking. Those steps are very comprehensive. In some particulars the bulletin is narrower in its scope than the practice of my firm.

Q. Would you say that if you left out such of the steps as were not applicable to a particular case because the conditions are not present, that the remainder would be in the nature of a minimum procedure?

A. I would be willing to go along with you if we bear in mind constantly that discretion and judgment of the responsible person in charge of the engagement must finally determine which steps to omit and what additional steps to pursue.

Q. You may have answered this question, but I would like to have you repeat it, if you will. Speaking generally, how would you compare the scope of the examination by your own firm with that contemplated by this bulletin?

A. I believe that in general the examination of my firm in some respects, but not in all, is somewhat more comprehensive in scope than that suggested in the bulletin.

That is particularly true of cash items, payables, and greater insistence than, I believe, is contemplated by the bulletin, despite its language, with respect to direct verification or confirmation of receivables.

Q. Looking back to the time of publication of this bulletin, do you believe that its publication resulted in any general changes in auditing procedure or resulted in changes in your own procedure, in this type of examination of course?

A. My guess is that the publication of the bulletin may have served to help increase to some degree standardization of practice. As in many other fields of endeavor, a text or outline frequently tries to set down existing practices rather than to advocate or inspire the use of new and experimental devices and procedures.

From this point of view I would say that the publication of the bulletin did not lead to changes in the practice of my own firm or in the practices of other firms generally. It may be added, however, that in the discussions with clients as to the scope of the examination the fact that reference could be made to a publication which was issued under the aegis of either the Federal Reserve Board or the Institute, its successor, played its part, a not inconsiderable one, in convincing the clients that the representations of the accountant as to the necessary extent of the audit were well founded and of weight.

III. OFFICE METHODS AND STAFF ORGANIZATION AND TRAINING

Q. Now, in the questions which will follow, Mr. Klein, I would like to have you distinguish between practices that were in effect prior to the present proceedings, the McKesson & Robbins proceedings, as compared with those which may have developed subsequently, if you will just indicate any such differences.

When a client comes to you, Mr. Klein, do you make any independent investigation of his reputation or credit rating?

A. Normally, clients are recruited from those among whom we have varying degrees of acquaintanceship and through the recommendations of banks, credit grantors, investors, and other clients.

It is extremely rare to have a client walk in off the street, as it were. We have on rare occasions and for various purposes, even during the progress of an audit, secured Dun & Bradstreet's reports on clients and in a very few instances Bishop's reports. On a number of occasions we have refused to accept engagements from concerns which we knew or learned had unsavory reputations. Other accountants would undoubtedly act in the same manner under similar circumstances.

Q. From your experience—

A. There is no difference in this respect as before and after the McKesson case.

Q. I think if where there are differences you would indicate that fact it would be satisfactory. From your own experience, Dr. Klein, who would you say exercises the prerogative of appointing auditors in the case of corporations whose stock is publicly held, auditors for the purpose of certifying annual reports, for example?

A. Usually one of the executive officials offers the engagement, with or without prior consultation with directors. However, regardless of through whom the engagement comes, the primary responsibility at present is toward the members of the board, not in their individual capacities but solely and exclusively as representatives of the owners.

Naturally, the statement bearing the independent accountant's certificate should be so prepared as not to mislead either the owners or others.

Q. When you say "owners," do you have in mind also the public creditor such as bondholders?

A. I think that would be covered and is intended to be covered by "others" in my answer.

Q. When accepting an engagement for the purpose of certifying annual reports for the S. E. C. or otherwise, by what representative of your firm is the scope of the audit determined?

A. Always by a partner. In relatively unimportant engagements the in-charge senior may suggest the scope but the final determination is by a partner.

In some instances one partner may consult with one or more other partners before reaching a determination.

Q. Is it customary for you to reexamine the scope of the audit in the case of a continuing engagement?

A. After the scope has been initially determined, it is subject to modification and change at the recommendation of the person in charge of the engagement and subject to partner's approval, of course, if circumstances arise during the examination which indicate need or desirability of change in scope. During the slack season in my office, audit programs are regularly reviewed.

From time to time a partner may dictate a memorandum for placement in the permanent file with respect to a specific step in the auditing program or part of the procedure, as a result of an occurrence or experience in connection with some other similar engagement. More or less parenthetically, revision of examination programs throughout the years has steadily tended to increase the scope and volume of the work performed.

The tendency has never been in the opposite direction.

Q. Would you say, generally speaking, that in the case of a second audit—that is, the second year—that the general scope of the examination is reexamined at the time of the second audit or prior to beginning it, or do you utilize the audit program you had the first year with such changes as may have been put into effect during the slack season, or otherwise?

A. I doubt that such revision would occur immediately prior to the beginning of the second engagement. If the change were made, it probably would have been made immediately after the completion of the first engagement, and in connection with the partner's review, or during the slack-season review that I have already referred to.

Q. That is, you wouldn't treat a subsequent audit as a wholly new problem to develop the scope of audit covering the situation, but would refer back to your earlier audit and make any changes that have been determined to be desirable as a result of your experience in that case or other cases. Is that correct?

A. That's absolutely so.

Q. Who would you say on the part of the client determines such questions?

A. As to the scope?

Q. As to the scope.

A. A client never decides the scope of the engagement. In consultation with the client, limitations of various steps in examination may be indicated and his request and desire given consideration. In cases where the examination program is abridged, we reserve the right to indicate in our certificate wherein the scope of the examination was less than satisfactory to us.

If, however, the client wishes the examination limited in scope beyond what we deem to be a minimum requirement, the engagement is not accepted, or, if already entered upon, is terminated.

Q. Now, looking to the future, do you have any recommendations to make as to changes in the method of appointing auditors or in determining the scope of their audit?

A. I am familiar, reasonably so, with the various suggestions made to have accountants selected by the stockholders at the annual meeting. I sympathize with the motives that prompt the suggestion, and I am familiar with the British and Canadian practice of the

premise. I am quite convinced, however, that under established American procedure and under existing circumstances the suggestion will prove quite impracticable. The stockholders may go through the motion of selecting the accountant, but the effective nomination will, undoubtedly, come from the board.

Probably the most feasible procedure and one which, at the moment I favor, is to have the selection made by a partially rotating committee of the board, the majority consisting of nonexecutive members of the organization. This committee should consult with the auditor in connection with the determination of the scope of the audit.

Q. Would that appointment come at the close of a fiscal year for the audit of that year or the beginning of the year to be audited? I mean, have you any recommendations there?

A. I am entirely in favor of appointments at the beginning of the year to be examined, although I am inclined to believe that some exaggerated value might easily be placed on such early appointment; that is, easing of pressure at the end of the year as a result of the opportunity continuously, more or less, to be in touch with the engagement.

Q. Now, turning to the organization of your own staff, Mr. Klein, do you classify your personnel into such categories as seniors and juniors?

A. We have a rather simple classification, aside from the partners. The in-charge, or supervising senior, seniors, semiseniors, and juniors.

Q. When an engagement is accepted, how do you determine the personnel to work on a particular audit? That is, how are the partner and various other people selected?

A. The partners determine the matter amongst themselves, depending upon their relative busy-ness, and also with due regard to their experience in special fields. Assignments of seniors and others are made by the partners in consultation with the person in charge of personnel.

In making such assignments, qualification, experience, type of business, are factors which are, of course, taken into consideration.

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

A. We try to make partial rotation of men assigned to continuing engagements. We try to change a senior in charge at least every 3 years.

We find on occasion considerable resistance on the part of clients who very generally prefer to deal with the same top men.

In a recent experience we found it easier to acquiesce to the client's insistence in having the same supervisor on the engagement, but we went to the expense of having another supervisor there who was really in charge of the engagement.

The reason why we favor rotation is that this constitutes a sort of self-internal control. We feel that it is well to have different men assigned to a given engagement because differences in points of view and training are, we feel, a desirable element.

To some slight extent it is also well to rotate so as to avoid the possibility, perhaps very remote, of creating a too-friendly relationship between members of the staff and client's personnel.

An added reason is to afford members of the staff opportunity to have a wide experience with as many types of businesses as is possible.

A still further consideration with respect to rotation of top men is that it is administratively wise to have at least two men sufficiently familiar with a given engagement if it is sufficiently important; to be able to have more than one man assume charge, if necessary.

Q. When you speak of top men, do you refer there to the senior in charge, or the supervising senior, or the partner, or what?

A. It is the key man who will be the supervising senior. We assume, perhaps without full justification, that the partner can take hold of any job.

Q. Is there any similar rotation as to seniors in charge or as to juniors? Or does that take care of itself?

A. In making assignments, very little consideration is given to rotating juniors or semiseniors for the purpose of—for one of the purposes mentioned. Such rotation would be for the purpose of affording the juniors an opportunity for wider experience.

Q. Now, I think there is just one group there that you haven't mentioned. That would be the senior in charge, as distinguished from the supervising seniors.

A. You must have misunderstood me. In our set-up a supervising senior and senior in charge are synonymous.

Q. I see. I was not clear on that point.

When you wish to make additions to your permanent staff, how do you go about recruiting them? Let us take the juniors first.

A. A number of partners and members of my firm lecture to students on accounting and auditing so that some little of the recruiting is done through such connections.

A great number of written applications for positions are received throughout the year. These are reviewed and the more promising men are interviewed by a partner.

Agencies specializing in placing accountants are also asked to submit their list to us from time to time, and we have on occasion consulted with the placement bureau of the New York State Society.

Sometime ago we cooperated in the endeavor of the American Institute to place the more promising graduates of the leading colleges.

Recently, placement bureaus associated with a number of colleges have been in current communication with us regarding their undergraduate and graduate lists.

Q. How about your temporary staff, how is that obtained?

A. The procedure I have outlined applies to some extent, but I should say less intensively with respect to the members of the temporary staff.

Q. Is there any policy your firm follows in taking men from the temporary staff onto the permanent staff?

A. I learned Saturday afternoon from a partner that those who are given temporary assignments are told that some among those on the temporary list will be added to the permanent list and that competition is wide open.

Q. Do you have any particular requirements as to training and experience in men that you are to select for your permanent or temporary staff?

A. Years ago I was in charge of and constituted the sole faculty in our own office training school. During the past few years we have encouraged our men to go to the very admirable schools in the

metropolitan district so that formal training is no longer a part of our office program.

We have tried to restrict, especially I, personally, appointments of juniors to college men who have studied some accounting and who have at least 1 year's experience with other accountants and, preferably, 1 or 2 years of bookkeeping or allied experience.

On relatively rare occasions we have deviated from this policy in the case of men of outstanding scholastic attainments, but even there such beginners have not been sent out on engagements for some while; they have been restricted to office work.

With respect to recruits for our temporary staff, the requirements are less stringent, but it is planned to have the supervision of such temporary men greater, if possible.

I might add that no accountant, regardless of rank, is engaged except after a personal interview with at least one partner.

Q. In respect to promotion within your firm, do you have any requirements as to obtaining a C. P. A. certificate?

A. We bring pressure on those members of the staff to acquire it in whom we are interested because they hold forth promise of developing, to continue to pursue university courses in technical subjects and sometimes in report writing.

There are frequent staff conferences which, in real sense, might be compared to university seminars. Partners both instruct and participate in these conferences; to be entirely frank, I have not participated in them at least for a year.

It is now practically impossible for a person to secure substantial advancement within the ranks unless he is a C. P. A.

Q. Would you characterize, briefly, the type of duties which you customarily assign to juniors, as a group?

A. Juniors are entrusted with what might be designated as the clerical aspect of audits, that is, work including, but not limited to, additions, checking of postings, scrutinizing check signatures and endorsements, preparing the relatively minor schedules and, in general, work which is under direct supervision of more experienced members of the staff.

Generally speaking, the work of the junior involves detailed work which, while requiring alertness in detecting errors and discrepancies, nevertheless does not involve the exercise of trained judgment. On the theory that the chain is no stronger than its weakest link—and I am fully aware of the weakness of reasoning by analogy—there may, nevertheless, be some ground for belief that a really workman-like job cannot be done if the juniors are not fully capable of doing the tasks entrusted to them.

Q. Would you say the task you assign the juniors requires a knowledge of accounting or auditing?

A. Absolutely.

Q. But not as much as the higher ranking grades, of course. Now, referring to your seniors, as a general matter, from what sources do you obtain your seniors?

A. In general, seniors are recruited from within the staff. It is becoming increasingly difficult to obtain seasoned seniors from the outside. The qualifications expected of seniors are naturally much higher than those of juniors and semiseniors—wider experience, both

in time and scope, established character and integrity, qualities of dependability, alertness, vision, imagination, application, and so forth.

Appearance, bearing, and presence are considerations which are not overlooked.

Q. What type of duties are customarily assigned to such men?

A. In some types of engagement, the seniors are in charge of the field work and supervise our assistants. In more important or more difficult engagements, the seniors are assigned to specific examination tasks under the supervision of a supervising or in-charge senior. Frequently, the senior works under direct supervision of a partner.

Q. Do you consider it one of the senior's general duties to train the juniors or semiseniors who are working for him?

A. I have frequently stressed both the personal responsibility and the professional obligations of the more experienced staff members to guide, teach, and train their assistants and associates.

Such guidance, teaching, and training are informal; sometimes the junior or assistant is shown exactly how to perform a given task; at other times his work is criticized, the faults pointed out, ways of improvement indicated. Just as in most law offices, men constantly discuss among themselves points of procedure, questions of principle, bookkeeping and accounting errors discovered during the course of an examination, and so forth.

Q. How do you, as a partner, satisfy yourself that your juniors are actually performing a certain piece of work?

A. The work of juniors requires eternal vigilance on the part of their supervisors; their work is continuously scrutinized; they are questioned both about how they perform their tasks and for the purpose of ascertaining their understanding of what they are doing.

It is really comparatively rare that the work of a junior is repeated by someone else solely for the purpose of testing its accuracy. Those rare occasions arise when it is discovered that the junior has misunderstood instructions or apparently does not fully comprehend what he was assigned to do.

In the case of original work by comptometer operators, and we use quite a few, it is quite the universal practice that work is performed twice for the purpose of checking unless the comptometer's work is in the nature of checking additions or other computations already made.

Q. In the course of this supervision of the work of the juniors, do you feel that the senior should examine some of the original documents to see whether the junior has actually been doing what he has been told to do, or how would that be determined?

A. I referred to eternal vigilance and constant scrutiny. Part of the assignment of the senior is to stand behind the junior while he does some of his work and, when deemed necessary, to question him about it.

Q. Do you mean that physically?

A. Very physically.

Q. Do you have any system by which the seniors report to you the progress of juniors or make a report to you on the character of their work?

A. Not formal reports, but informally the seniors are questioned.

Q. Do the partners in your firm play any part in the actual carrying out of the field work of the audit program?

A. It is not usual for partners to participate actively in the conduct of field examinations, although they do so on some occasions.

It is customary for partners to visit clients most frequently during the course of the examination, but also on other occasions during the year. When partners visit clients, they consult with the chief accounting officer, who may be the comptroller or treasurer, sometimes another officer, not infrequently with the president of the organization and sometimes divisional chief in charge of various phases of the internal accounting work.

Sometimes, too, they may go through the plant or inspect one or more functional divisions, such as the receiving operation, the shipping operation, the merchandise stock control, etc.

Q. Are those visits with a particular purpose in mind, or a general visit, that when it is in the course of the annual audit, would also involve supervision to some extent of staff or watching them perform certain duties and discussing problems with them?

A. Many purposes. One would be lacking in frankness if one were to omit that one purpose is to have the client realize that the partner is interested in the work. Then there are specific needs, errors, and irregularities that have been discovered, they are to be discussed with the executive officers, faulty procedures to be pointed out, perhaps the trend of the client's progress is quite out of line adversely with that of general business or with other concerns in the same line, and we feel that a discussion on such subjects is comparatively helpful.

Q. Now, when you assign a staff to a new engagement, do you expect them to become generally familiar with the particular trade or industry in which the business falls which they are examining, at least prior to the completion of the audit?

A. We endeavor to acquire some familiarity with the trade or industry in which we have had no prior experience, just as we endeavor to learn the bookkeeping and accounting procedure and set-up of every new client.

Before the field work is actually started, there is a preliminary discussion between the partner and the senior in charge and, in special cases, during some part of such discussion, all of those assigned to the engagement may be present.

Naturally, additional familiarity is obtained during the course of the examination but by this I do not wish to be understood as implying that we endeavor to acquire, in general, more technical knowledge or information than we deem necessary for the proper conduct of the examination and understanding of peculiar problems and auditing pitfalls.

Q. Now, referring again for a moment to the juniors, do you expect your juniors to be sufficiently familiar with the type of records and documents with which they are apt to come in contact to be able to detect or recognize the significant irregularities such as the absence of an endorsement on a check, the absence of a date on a check or something of that sort?

A. Most documents constituting bookkeeping and accounting records, in principle, must be matters with which a graduate of an accountancy school must have become familiar.

Forms embodying such principles are manifold. It is the duty of the supervisor or in-charge senior to note what peculiar forms are used

by a given client and to make sure that the assistant, whether he be junior or more experienced, who is assigned to visé or to deal with such documents understands both their purport and their relationship to the task assigned.

As to irregularities in these documents, even in such simple forms as checks and invoices, I find it difficult to state how juniors can be taught to recognize them except through the medium of direct instruction. Such instruction occurs at staff meetings, at informal talks between the junior and his more experienced colleagues, and through the constant personal guidance which comes through association.

Alertness and experience are undoubtedly helpful elements. I am dealing with such matters as failures of correspondence in dates between the document and the entry relating to it, or a disparity between the amount on a check and the entry in the cash book, as well as the omissions of dates to which you have referred, because these are the matters with which the junior is called upon to deal.

Q. Do you expect him to be alert to detect and report such irregularities?

A. If we discover that he fails to do so with respect to these elementary matters, he is slated to go at the first opportunity.

Q. What instructions do you give your staff as to the course to be pursued when irregularities are discovered? You mentioned a moment ago that one of the purposes of a partner's visiting a client might be to discuss such matters. How would those things get up to the partner?

A. All irregularities and errors are supposed to be reported by those who come in contact with them to the supervisor. He decides on further procedure which, with respect to important matters, necessitates conference with the partner who then makes a final decision as to procedure and such procedure may involve, as I have already stated, a visit to the client.

Q. Would you say that you expect your staff to develop the facts so far as they can with respect to such irregularities before taking it up with the client or before they have you take it up with the client?

A. It depends on the nature of the irregularity. If defalcation is suspected, the supervisor would at once take the matter up with the partner before proceeding further unless the bookkeeper or cashier would be detected in an overt act and be observed in his crime commission. If the matter involves procedure or irregularity, the matter would undoubtedly be investigated thoroughly in the field before it would come to the attention of the partner.

IV. CONDUCT OF THE EXAMINATION

A. INTERNAL CHECK AND CONTROL

Q. Now, turning to the system of internal check and control followed by a particular client: To what extent do you require the members of the staff assigned to an engagement to become familiar with the particular concern which is being audited, that is, with its method of doing business, its plant lay-out, if it has a plant, the character of its personnel, the nature of its product, perhaps, and so forth?

A. I believe I have in effect anticipated this question in my response to question 39. In general, only the partner and senior in

charge would be expected to be familiar with plant lay-out and that generally rather than technically.

These people would also try to become familiar with methods of operation, the general nature of the client's product and more with the functions of the client's personnel than with personal character.

Q. Do you obtain or develop an organization chart or its equivalent which would outline the accounting duties performed by various people and the lines of control that are established between them?

A. Sometimes the organization chart is a very formal document; sometimes it is informal; but invariably it is obtained but not restricted to those engaged with the accounting and financial operations.

In our set-up we obtain a similar chart with respect to receiving, shipping and warehousing, or stock operation.

Q. Is that always in the form of a chart, or is it sometimes in the form of a memorandum of those duties? Perhaps I am pressing the definition of charts a little too far here.

A. Sometimes it is in the form of a picture, a graph. Sometimes it is merely descriptive and almost usually it is a combination of both, I should say.

Q. What do you understand to be the meaning of this term internal check and control? Would you indicate some of the important features of such a system?

A. In general, the expression "internal check and control" relates to a subdivision of duties and responsibilities among employees so as to minimize the opportunity for theft, speculation, falsification of records, and commission of errors, by requiring collusion among at least two persons for the perpetration of crime or double errors to escape detection of such errors.

The usual classroom illustration is the segregation of the duties of the cashier so that he makes no entries in and has no access to the books in which are kept the accounts with customers.

Another similar illustration is that the disbursing officer is similarly to have no access to the books with creditors, and that all payments shall be made on the basis of vouchers, approved by others than the disbursing officer.

Similar applications are found with regard to pay roll and stock. Obviously the system to which you refer can be used only where the number of employees permits subdivision of duties.

The relationship between the matter discussed and a system of internal audit is quite tenuous. The latter refers to a function of client's employees somewhat similar to that of the independent auditor, but restricted to continuous checking of the work of all of those who are concerned with recording of transactions and the handling of cash and merchandise. I believe I have gone a little beyond your question.

Q. One thing in there interests me. You say that the system of internal check is based on a segregation of duties so that except by double error or collusion of at least two people, the trouble would not be discovered. When you say not be discovered, you mean not be discovered in the ordinary course of the system of internal check?

A. You are putting reverse English on the answer. I meant that the successful crime or the undetected error is possible under such a system only if at least two people conspire in the planning and the execution of the crime, or if at least two people are asleep at the switch and do not detect an error.

Q. When you say not detect it, by whom do you mean?

A. By themselves.

Q. The operation of the internal check?

A. I have no reference in my answer to the work of the independent or of the internal auditor, but entirely to matters which occur within the organization whether or not there are independent accountants or internal auditors.

Q. And presumably no reference to an internal system of audit in that connection?

A. No; I tried to differentiate the internal check from internal audit.

Q. I had this in mind. Would you say that an internal system of audit, the operation of such a system might detect this even though the system of internal control might not turn up the difference?

A. One of the primary functions of the staff of internal auditors is to do that very thing, to detect.

Q. Now, the bulletin at page 7 states that the nature and extent of the examination depends upon the purpose of the examination, the amount of detail included in the statement to be covered by the report, the type of business which is being examined and the system of internal check and control.

Can you explain briefly the effect of each of these factors upon the scope of the examination to be made?

A. I believe I can. Naturally, the purpose of an examination must determine the scope and extent of the accountant's work.

If it is a so-called balance sheet examination or, as the bulletin denominates it, examination of financial statement, verification of assets and liabilities constitute the primary purpose, verification of operating results is somewhat subordinate.

If the examination is for the purpose of determining the amount of bonus payable to executives, for example, such fact will obviously determine that the examination should, so far as is practicable, be restricted to the net income or earnings on which the bonus is to be calculated.

What I have said covers to some extent the amount of detail which is to be included in the independent accountant's report.

The type of business may determine the emphasis on accounts to be examined. For example, in an investment trust, the existence of cash and securities must be thoroughly verified as must also income from investment.

In an office building corporation, probably verification of rental income may constitute the major item in the examination.

The system of internal check and control may well influence the extent of test checking.

Q. Would you say, generally speaking, that the importance of a particular type of asset or revenue or expense to a particular business is reflected by an adjustment of the scope of the audit to give greater attention to that asset or source of revenue or expense?

A. The relative importance surely does govern and determine it.

Q. On pages 7 and 10 of the bulletin it is indicated that section 2 is designed for application to small or moderate-sized businesses, and that section 3 is for businesses which are larger or smaller than those contemplated by section 2.

What, to your mind, is the criterion by which size for this purpose is established? Is it volume of transactions, total assets, or what?

A. The size element to which you refer is undoubtedly not determined by any single factor. The size and the net worth of the concern, the volume of sales, the volume of transactions are all to be taken into consideration.

While there can be no doubt as to whether one is in the presence of a large enterprise or of a small business, I know of no absolute criterion by which it is possible to judge the difference, nor do I think that the matter is of any practical importance.

And may I state somewhat diffidently that you must not let the pamphlet from which you are quoting be regarded as either infallible or omniscient or the last word on the subject with which it purports to deal.

I do not wish to be understood as not holding the pamphlet or bulletin in the esteem to which it is entitled, but I also wish to avoid the implication that I exaggerate its importance.

The men who constituted the committee which produced the pamphlet did a splendid job. I do not mean to imply that the mountain labored to produce a mouse, but I would be less than frank if I permitted you to believe that the pamphlet is not as fallible as the human beings who produced it, especially when what was written must have been the result of the give-and-take of compromise.

Q. Again, at page 9 in the bulletin it is indicated that the extent of the examination is to be determined, in part at least, on the basis of the accountant's knowledge of the individual situation.

What is your understanding as to the extent of such knowledge of the individual situation that the accountant should have, either before he commences the audit or at least before he completes it?

A. Before completing any examination, the partner and the supervising senior should have a thorough knowledge of the extent of the internal check and control, the type and completeness of the records, the nature of the client's business, the product produced or handled, the effectiveness of the organization as measured by tests of accomplishment, both with respect to past periods and in relation to similar organizations and general business trend.

On further consideration I add: I should say that the extent of the examination, which really means the extent of the test checking determined upon, would depend essentially on knowledge of the existing internal check and control and the knowledge and training of the bookkeeping, accounting, and clerical staffs of the client as indicated by the correctness and accuracy of their work.

Such knowledge on the part of the accountant would naturally be greater at the completion of his first engagement than at the start thereof, and such knowledge should become increasingly greater and more dependable, within limits, from year to year.

It follows from what I have said that regardless of the predetermined extent of the test checking at the commencement of the first

engagement, developments during such first examination may and do bring about revision in the audit program as the work proceeds, so that the initially decided-upon program may very well be modified during the course of the engagement.

Q. What methods do you employ for developing this information about the client's accounting procedure and the system of internal check and control?

A. Originally, the information is usually obtained as a result of a preliminary inspection or survey which includes discussions both with executive officers in charge of accounting and some of those in charge of the divisional activities.

During the course of the audit more detailed and comprehensive information is developed as a result of observation, scrutiny, and actual contact.

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

A. My firm does not employ formal questionnaires. The examination program itself provides for the notation of procedures observed, of items affecting internal check and control, and related matters.

Functionally these data cover the same ground as the more formal questionnaires to which you probably refer. Instructions to those assigned to the engagement require quite comprehensive description of the accounting and bookkeeping procedures with emphasis on the presence or absence of internal check and control elements.

Q. Are these facts, as discovered by the senior or whoever makes the inquiry, reduced to writing and placed in your file on this particular client?

A. They are made part of the work papers and those which are important are removed from the current file and put into what we call the permanent file, which must always be reviewed at the commencement of an engagement.

Q. Which is your starting point for the next one?

The EXAMINER. We will take a 5-minute recess.

(Thereupon, a short recess was taken.)

AFTER RECESS

Q. (By Mr. WERNITZ.) Now, Mr. Klein, coming back to your procedure with respect to establishing the system of check and control, How do you determine that the procedure said to be followed actually is being followed?

A. Information is sought from all of the sources that might be enumerated.

For example, information obtained from employees with whom we come in contact who perform the various duties, also from their immediate supervisors. Sometimes from administrative officials.

It is an integral part of the audit program to determine the extent to which the ostensible system of check and control is being observed. This objective is accomplished by questioning and observation—observation of those whose functioning constitutes the system, and to some extent by interviewing more responsible employees and officials.

Q. Would you say that to any extent you determine this from observation of the records resulting from operation of the accounting

system, such as, for example, proper signatures on checks, proper initials on vouchers, and the like?

A. Primarily in that way, but also by watching those who are performing their tasks, just as a supervisor on occasion watches his own juniors.

Q. Now, if your study of a system of internal control has resulted in your finding what you feel to be weaknesses, would that result in additional steps in the audit program, or might it result in additional steps?

A. If what the auditor colloquially refers to as "leaks" are found to exist then the extent of the test checking must be increased and in some instances complete examination must—might have to be substituted for tests.

Q. If the company objects to that work, or finds you are doing it, what position do you take? Do you take it up with them before you do the additional work or go ahead and do it?

A. If in preliminary discussion the client has been led to believe that tests only were to be undertaken and if, in connection with such preliminary discussions, some indication of approximate fee had been referred to, the fact that additional work was being undertaken would, undoubtedly, be brought to the client's attention, but if those considerations were not present, we would simply modify the audit program and pursue what we believed to be indicated procedure.

You asked, did you not, what my firm's practice would be in the event that the client objected to the additional work which we deemed to be necessary?

Q. Yes.

A. My answer is that the rule of reason applies. In some instances a qualification of the certificate may be necessary. I do not personally recall any instance in which the situation was found so radically wrong or dangerous as to make continuation of our services impossible, but such a situation is readily conceivable.

Q. And would there be situations in which you would go ahead and do the additional work even though no additional fees were received for it?

A. Unfortunately, that has to be done on occasion.

Q. Now, when you have completed your study of the system of internal control, do you think that this study should result in a thorough knowledge on the part of the auditor as to the accounting system followed by the client, including a knowledge as to what documents, vouchers, and other papers are used to support the various steps in the procedure?

A. A survey of the accounting procedure, as well as a study of the system of internal check and control, should and does furnish the auditor with sufficient working knowledge of the types of document, the vouchers and other papers required to justify and verify the procedural steps and entries in the records of the client.

I would hesitate, however, to emphasize that the knowledge thus obtained is invariably thorough. I should say that the knowledge is sufficient for practical purposes.

Q. Do you mean by that that in each examination every paper, voucher, and so forth is examined, or that the knowledge to which you refer is a knowledge of the type of paper?

A. Only as to type of paper.

Q. Do you feel that an examination in accordance with the audit lines of this bulletin should disclose fraud? You might in that connection refer to the second sentence of the second full paragraph on page 10 of the bulletin which reads as follows:

The procedure will not necessarily disclose defalcations nor every understatement of assets concealed in the records of operating transactions or by manipulations of the accounts.

A. Such examination is not directed toward the disclosure of employees' fraud, but frequently it does disclose such fraud.

I assume that the sentence quoted is intended to be cautionary, that is, that the client, the credit grantor, the investor, and those who read the accountant's report should realize that because the examination did not involve investigation of every transaction, but was limited to tests, the recorded transactions to which the defalcations or understatements of assets corresponded—the so-called manipulative entries, may have gone undetected.

Of course, the auditor should satisfy himself as to the general accuracy and integrity of the records; if he is not so satisfied, he should issue no certificate or clearly set forth his qualifications and doubts.

Q. Have you any opinion as to why the sentence quoted a moment ago does not refer to overstatement of assets? It refers to defalcations and understatements.

A. I did not intend to damn the bulletin with faint praise; it is a human document. I am inclined to believe reference to overstatement of assets might appropriately and logically be interpolated.

Q. I was just wondering if you knew of any reason why overstatement was not included there.

A. I don't recall any at the moment.

Q. Now, within the scope of the examination contemplated by this bulletin, do you feel that the auditor should be alert to detect any fraud or other irregularities?

A. The answer is obviously yes. If fraud or irregularities exist, the auditor is obviously keenly anxious to make the detection.

The fact is that the type of examination to which you refer, frequently does detect fraud, error, and irregularities.

I have no available statistics, nor do I know that they exist, but I venture the guess that throughout the year literally scores of thousands of errors, thousands of irregularities, and hundreds of frauds are detected by the very type of examination which disclaims such detection as either an objective or as the consequence of its procedure.

Moreover, I am convinced that knowledge that auditors will detect errors and irregularities when they examine the accounts has acted as a deterrent on those who otherwise would practice fraud and deceit.

May I add, gratuitously perhaps, that there is ample proof available even in the publicized cases that the existing procedure does detect fraud.

The downfall of Kreuger, onetime match king, resulted from a routine examination by American accountants who, in a sort of collateral matter, detected improper claims as to cash. The suspicion thus aroused may be said to have started the train of circumstances which led to Kreuger's suicide and then to the disclosure of his gigantic frauds.

While I hesitate about becoming personal, I believe I am justified in stating that the McKesson Robbins auditors, Price, Waterhouse and Co. are the American auditors to whom I refer.

Q. Now, looking at the whole procedure as contemplated by this examination, is it your practice to make test examinations of records covering certain types of transactions in connection with this type of examination, such as sales or cash receipts, disbursements, and the like?

A. Tests are used in many fields for the purpose of judging the mass. Thus, in a school population, 10 percent of the students might be sampled for the detection of tuberculosis. The result of such tests would be relied on for determining policy with respect to the examination of the remaining 90 percent.

It is our practice to test sales, stock records, shipping records, other documents, for 1 or more months and to scrutinize relatively large transactions throughout the period under review and to scrutinize all, and much more completely, important transactions of all types, including more important additions to plant and the correlative charges to operations which should have been capitalized and vice versa; cash receipts and disbursements for 1 or more months, more of the relatively larger disbursements, and all sizeable disbursements for special or unusual purposes and, generally, to test the correctness of charges to expense.

Now, the question may arise as to the adequacy of such tests. I have no doubt that such tests, if adequate and properly pursued, justify the belief that the remaining records are as satisfactory, no more and no less, than those which have been tested.

This does not mean that I believe that tests conclusively verify or establish as correct any of the records or entries not specifically examined. Nevertheless, experience by and large warrants the belief that the tests which I have described, can be relied upon under normal and ordinary circumstances.

Q. Do you believe the percentage of sampling might well be increased, say, from 1 month in some cases to a month at the close of the year and 1 or more random months during the year?

A. When I said 1 or more months, I had in mind that very procedure, the final month always; as many more months as circumstances indicate to be necessary or desirable.

Q. The extent of that sampling, you feel, should be left to the auditor under all the circumstances of the case?

A. I think it should be and can be left to him because, on the one hand, there is the human motive to increase the volume of work, and therefore the fee; and, on the other, to be professionally decent and honest and not to perform unnecessary tasks.

B. CASH

Q. Now, coming to some of the detailed parts of the audit program and taking first the question of cash, do you consider the cash program outlined on pages 11 and 12 of the bulletin to be a minimum or maximum program?

You might indicate the steps therein which you customarily omit or any steps which are ordinarily added to that program.

A. None of the 11 steps referred to are omitted in principle. The extent to which they are employed may vary with different engagements.

Then, there are other steps that my firm takes, customarily, including a second cut-off and a request for duplicate bank deposit slips for a short period prior to and a short period immediately after the balance sheet or cut-off date.

With respect to that second step, we have under discussion, but have not yet modified our program because of the increasing use, by banks at least in the metropolitan district, of the so-called blocking system of checking deposits—a system which substitutes a totaling of deposit items against the total shown on the deposit slip for the earlier procedure which involved a check by the receiving teller, or his assistant, of each item listed on the deposit slip with the item on the slip.

Q. Would you indicate in what respect that blocking system detracts from the value of the tests you mentioned? That is, duplicate deposit slips.

A. Let me illustrate. The bookkeeper has forgotten, accidentally on purpose, to deposit a receipt of a thousand dollars, he has failed to enter the item as a cash receipt and has failed to give credit to the customer from whom the remittance was received. Before the balance sheet date he employs three checks, one in the amount of \$250, the other \$350, and the third of \$400, to cover up his defalcation by crediting the customer who had remitted the thousand dollars with the aggregate of the three checks and temporarily failing to do likewise with respect to the three customers.

On his deposit slip he has entered one check of \$1,000, instead of the three separate checks aggregating the \$1,000. When we receive back that duplicate deposit slip from the bank we might be misled if we did not know of the operations of the blocking system; the record on the deposit slip may not be actually what it purports to be.

Q. Now, is there any auditing procedure that you know of that would overcome that difficulty or provide a similar testing of the bookkeeper's work, that is, similar to the old method of comparison with deposit slips?

A. We are wrestling with that problem now. No solution satisfactory to ourselves has been found. It is on the partners' agenda for the first partners' conference after the Ides of March have passed and the one suggestion that comes to mind now, which I hope will be improved upon as a result of further cogitation, is that just as we ask, on occasion, that the canceled bank vouchers should be delivered to us personally instead of being entrusted to the client, that we should be permitted directly to have the cooperation of the bank on a predetermined date to have the deposit slips actually checked against the items deposited.

Short of that, at this moment, I would not venture a guess except to anticipate what I shall have occasion to say later, namely, that the confirmation of receivables would indicate an irregularity, but would not disclose the precise type of irregularity.

Q. Do you know whether any of these banks using the blocking system also make photostatic copies of the items received in connection with the various deposits which could be obtained?

A. Quite a few of the banks use a photostatic device with respect to withdrawals, photographing both the obverse and reverse sides of the check.

I do not know if the procedure to which you refer is feasible or possible. I will venture the guess that it is not being done. The cost would be rather excessive and the justification from the bank's point of view would be absent.

Q. Would it be possible, perhaps, to arrange with the banks to have photostatic copies of the deposit material made of particular dates in advance? Could that be delivered to the auditor?

A. By special arrangement that could be done, in my opinion, as effectively as the actual checking and it may very well be, sir, unconsciously you have made a wise and constructive contribution to the solution of the problem.

Q. May I ask you another question about this system? If the total amount of a particular deposit does not agree with the deposit tickets, that is all but a few cents, do you know what the procedure of the bank is in that case? Would they then go back and check the detailed items?

A. I do not think so. I think their first step would be—their first step would be to re-add the cents and then the temptation would be great to check the individual items.

If there are just a few cents involved in the difference, it might be permitted to go into the cash-over and cash-under account, which every bank maintains. I am sure that if the number of deposit items involved were 1,000 and the difference was, say 13 cents, it might be passed by.

Q. However, unless the deposit tickets always agreed with the sum of the individual items, there would be the possibility, from the depositor's point of view, that a further check be made?

A. In our experience, sir, it is the honest person who makes errors. The crook who is working this scheme will see to it that his additions are perfect.

Q. Now, at page 33 of the bulletin, reference is made to reconciliation of bank accounts by employees independent of the cashier's department. How important do you consider that matter?

A. Oh, the step referred to is an essential part of an effective system of internal check and control.

If the auditor is satisfied that this step is regularly taken, adequately performed, it will influence the extent of his own checking, especially with respect to funds which are relatively small.

Mr. WERNTZ. Off the record.

(Discussion off the record.)

Q. (By Mr. WERNTZ). In the third line of item 8 on page 12, what is your understanding of the term "bona fide receipts"? How would you establish they are bona fide?

A. I would assume, on the positive side, that the expression refers to receipts resulting from transactions with customers by way of liquidation of accounts, collections of notes receivable, or the result of loans from banks or some other similar source; on the negative side,

that they did not represent kiting operations or transfers from one bank account to another without a charge against the bank from which the withdrawal was made.

Q. Does that phrase have in your mind any determination that these people are customers? You say they report receipts from customers. Does that contemplate any determination that these people whose checks you see or have evidence of were customers?

A. Not otherwise than as represented by the records and subject to check and confirmation by the auditor.

Q. Or any special information you might have?

A. That is correct.

Q. Is it customary and proper in your opinion, Mr. Klein, to include in cash amounts which are due from foreign banks or from private bankers or are there any conditions under which it is improper?

A. Ordinarily, it is proper to include in cash amounts due from domestic as well as from foreign banks, and from ordinary as well as from private bankers. It is not customary to include in cash any items but free balances withdrawable upon demand and, of course, it is improper to treat as cash items those with respect to which there are blockage and withdrawal restrictions, whether private or governmental.

It is quite inconceivable that any auditor would be unaware of the fact that there are such things as blocked currencies, Government restrictions on withdrawals of bank deposits from a number of foreign countries, and that at times some domestic banks are in financial difficulties. In the absence of specific knowledge with respect to individual bank accounts, an examination of the several accounts, including reconciliations, should indicate such absence of activity as to result in the propounding of questions which would elicit the necessary information.

Matters like these are also the subject of general conversation and knowledge among those employees who handle cash so that the matter would, under normal circumstances, be brought, routine-wise, to the attention of the auditor.

Q. If you were dealing with foreign balances in particular cases, would you make it a special point to determine whether there were any restrictions on those balances?

A. If the flow of cash in and out indicated there weren't, there probably would be no further question. If there was a large stationary balance which was never depleted the question might arise whether the restriction was not a partial one, that is, with respect to a fixed amount.

Q. When you say flow in and out, do you mean the country or that bank account?

A. That particular bank account as reflected in the records examined.

Q. Take a deposit in some country with a blocked currency. There would be a large number of items going in and out of that bank account within the country, would there not?

A. Yes.

Q. How would you determine that it was blocked so far as getting it out of the country was concerned?

A. First there would be general knowledge, there would be inquiry. We happen to have had unusually wide contact with that phase of the problem in connection with our examination of the Krueger Corporation, the International Match, with about 100 foreign subsidiaries, so I am charged with knowledge. I doubt that the general information, culture of the professional accountant is so low that he wouldn't be aware of that very phenomenon.

Q. I wonder if he would make it a point to make an investigation. Suppose he has a balance in some foreign country. There is a conflict in his reconciliation of that account, of that fund. You say in the case of a large flow of funds—how would he determine it was over in that country or here? Or if he didn't make that, would he make an investigation of general interest from a bank to see whether that country would have any restrictions?

A. Assuming he didn't know?

Q. Yes, assuming he does not know about this specific country. Let us take Persia for the moment.

A. We are the creatures of our environment and training. I just can't conceive of an experienced accountant not asking, at least occasionally, as a matter of interest, "How are things in Persia?"

Q. That is what I had in mind. Would he not make a special inquiry of some sort to determine whether there were any restrictions with respect to that balance?

A. I believe at first he would make casual inquiry. If the answer were reassuring he might very well drop the inquiry in the presence of such a flow of activity as I have referred to. Probably some of the most satisfactory accomplishments in life are accidental. He might stray upon something which nobody ever thought of before.

Q. Do you have any procedures which you follow to determine that a particular depositary is in fact a bank or banker?

A. I have given considerable thought to the question and I will say that, normally, the letterhead of the bank or banker, checks drawn thereon, and monthly or other statements from this source, confirmation in response to the auditor's inquiries, all tend to stamp the entity, as being what it purports to be.

One does not assume that he is dealing with abnormal conditions. I have already referred to my firm's engagement in the Kreuger case after Ivar Kreuger's suicide. Kreuger had established a sham bank in Holland, Nederlandsche Bank voor Scandinavischer Handel, which institution, we found had delighted in confirming the existence of nonexistent bank balances and the custodianship of nonexistent and fictitious securities.

Despite the knowledge of the auditors that such things may happen reasonably, even in our own country, established procedure justifies the assumption that clients are not officered by crooks.

It would be a sad day for all of us if it should ever become necessary customarily to regard every neighbor and every client as crooked and fraudulent. Having said this, let me add that if an auditor were to come across a relatively large deposit in a small country bank or a certification of custody of a relatively large block of securities from a similar institution, special investigation would be undertaken.

In a few instances, as revealed by congressional investigations of the post 1929 bank failures, it was found that confirmations, even

from banks which theretofore had good reputations, proved not reliable in every instance.

Q. When you say a relatively large balance, would that be a balance at the close of the year only?

A. Normally, yes; because if there had been a balance of \$1,000,000 which now had become \$1.59 by withdrawals, the interest at the end of the year would be rather slight.

C. ACCOUNTS AND NOTES RECEIVABLE

Q. Now, looking at item 3 under accounts receivable, what do you understand to be the meaning of that first sentence:

Examine the composition of outstanding balances.

A. A number of things might be meant:

(a) That the items constituting the balance correspond to specific invoices of recent date;

(b) That the balance is not to a material degree the result of unadjusted discounts and allowances and disputed items of long standing;

(c) That the items do not consist, in whole or in part, of debit balances in creditor accounts, of amounts due from officers or employees, and, in general, that the charges did not grow out of transactions other than sales;

(d) Aging of the accounts.

Q. What sort of examination do you make to establish or to take into consideration those various things?

A. The aging of accounts, I suppose, is too elementary to refer to unless you wish me to.

Q. I would be glad to have you do it.

A. In aging accounts we work backward and determine which balances are current, depending on circumstances which, in turn, determine the classification; 30 to 60 days past due, perhaps 90 days past due, perhaps a year past due, or longer than a year. That examination is frequently predicated on analyses prepared by the client against which we check.

Larger balances outstanding for relatively long periods of time are made the subject matter of special investigation.

Q. How far back in an account do you go to determine the age of a balance, back to your longest cut-off; that is, 1 year, or whatever it is?

A. If the balance is a year past due it ought to be examined carefully by collectors and attorneys and others. We lump those year-old items; in some cases perhaps after 6 months.

Q. Are those other factors you mentioned the first three or four given consideration in the process of the aging?

A. No; in the analysis of the accounts which were selected for testing we note the component items. Now, the third one that I mentioned, "Debit balances in creditor accounts," the absence of sales charged would clearly stamp those to be what they are.

If there is an attempt made to hide withdrawals by officers as normal accounts receivable, the same factor, absence of sales; we ought to be familiar with the names of the more important officers, of course.

The unadjusted balances would be indicated both by irregular amounts and by their age. We would not, of course, concern ourselves about most current adjustments. The test with respect to recent invoices is a very important one because a truly current account ought to be opened only with respect to the current invoices, which is only another way of saying it is of recent dating.

Q. In connection with your study of individual accounts for that purpose, do you examine their composition along the lines to see whether there is a concentration in particular months which may be off-seasonal or the presence or absence of unusual credits for write-offs of claims and allowances? I think you covered that in part a moment ago.

A. I think something can be added. In an ordinary balance-sheet examination, the end-of-the-year concentration characteristics should not escape notice. Concentration may, and often does, prove to be regular and proper but it invites investigation.

Checking of the sales shortly before and shortly after the closing date should reveal that fact. Significant items are frequently shown on the work sheets at least as percentage or ratios.

Out-of-line trends would thus be noted and if, upon examination, were found to be improper or irregular would require and have further investigation.

The absence of special credits of the kind to which you referred would not, in my opinion, have occasioned any astonishment in the past. It is very probable that for at least a little while in the future that will be made the subject matter of special investigation.

Q. In one of your earlier answers you said that you would examine the accounts receivable with a view to determining if any of them were from officers and directors. Would you also extend that to include affiliates, that is, affiliated companies?

A. Yes; for the purpose of the type of balance sheet with which we are dealing, but not for all purposes. There should be excluded from current assets the balances due from affiliates except in rare instances where the affiliate is treated as an ordinary customer and where the record clearly demonstrates that payments are being made as from an ordinary customer source and where we are satisfied that the affiliate is capable of so continuing to meet its obligations and where, most important, the balance sheet clearly indicates that the balance is from an affiliate.

Q. What study or what procedure do you follow to determine who are affiliates? That is, how do you go about locating those?

A. Normally, that knowledge is not difficult to obtain. The records of the corporation so indicate, the minute books, the fact of affiliation in connection with a corporation listed is a matter of public record in Moody's and similar manuals.

Q. You are thinking there, perhaps, of subsidiaries?

A. I was.

Q. How about around through a common parent, et cetera?

A. If you refer merely to corporations which are not in the technical subsidiary status, but with respect to which through relatively minor stock ownership or other arrangement, an economic affiliate status may exist, that fact, I think, would be disclosed if it were material because of the volume of business between the entities, the

size of the balances. Obviously, if the fact of the type of affiliation we are discussing were overlooked and the item were not material, no real harm would be done.

Q. I had in mind also a common ownership situation. For example, you are examining a particular company which is the subsidiary of a company which has other subsidiaries. How would you determine the names of those other cousins, let us call them?

A. If management were intent on concealing that relationship, the chances are that the present procedure in balance-sheet examinations would not detect the concealed fact.

Q. In connection with statements filed with the Commission where the parent company has statements on file, would you consult those statements to see what subsidiaries were listed there?

A. Normally, I don't believe that that is done, because it is unnecessary to do it. If a question should arise, if suspicion were created, that source should not be overlooked.

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

While such confirmation (speaking of confirmation of accounts receivable) 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 or, if not, are there circumstances under which you feel they should be confirmed?

A. I believe there is a broad hint there that one should not, under usual circumstances, miss this step. I should think from the linguistic analysis that might very well have been a compromise sentence.

There were those who may have said: "If internal check is adequate, do not confirm"; there are others who must have said in committee: "We always confirm," or "We like to confirm"—and you have the sentence which you quoted.

Now, there has been considerable difference of opinion in the past as to whether receivables ordinarily should or should not be confirmed. My firm has favored the practice for quite a number of years. Our ordinary procedure involves confirmation by direct correspondence of at least a representative cross-section of customers, and usually of customers with relatively large balances. Where the number of accounts is relatively small, cost cannot possibly be the factor to weigh against direct confirmation. This, likewise, is true where there are a small number of relatively large accounts. It is almost invariably the practice of my firm, and has been for quite a few years, to comment in the certificate if direct confirmation had not been made except in a few lines, such as installment selling, department stores, service concerns like dairies, where the number of customers is great and where you are bound to get no responses even if you undertook the very onerous and costly burden of attempting confirmation.

Q. Now, taking up the various methods of confirmation and having in mind both the cost and probative value of the method, do you favor the positive confirmation of as many accounts as is reasonably possible, the positive confirmation of a representative sample, or of all the large accounts and a sample of the smaller ones, or of negative confirmation?

A. Our preference, not always pursued, is for positive confirmation of all large accounts and of a fair sample of all of the others, and the reason for favoring positive as against negative is that all of the virtues of the negative are contained in the positive. If there is no response you have at least the equivalent of the negative. You do invite response more forcefully through the medium of the positive request.

Q. If you ask for a positive response and get nothing back, would not that be some indication that perhaps the thing was wrong?

A. Theoretically, yes; practically, no. In the case of questionnaires for stock-brokerage concerns where, in some instances, insurance coverage requires follow-up by means of registered letter, the percentage of response even to the registered-letter request is far from complete.

Q. Now, in making up your mind as to whether accounts receivable should be confirmed, do you give weight to the past credit and adjustment record of the account, or would you consider the fact as to whether they had been paid prior to the date of the completion of the audit?

A. The more complicated and irregular the account appears, everything else being equal, the greater the desirability of direct confirmation. That was true until a month or so ago. Now, I would be almost inclined to believe that you were willing to say I am not, that the more regular the account the more desirable is the confirmation.

The fact that the accounts have been duly paid prior to the completion of the audit (and especially if such collections have been traced to the bank) is frequently regarded—in my opinion, properly so—as tending to indicate less need of direct confirmation. I should be embarrassed to have to state that I am the only member in my firm that so feels. I have consulted four partners, and they agreed I was all wrong.

Q. The fact that an account has apparently been credited, paid off, subsequent to the balance sheet date but prior to the completion of the audit, would that disclose that there had been lapping? Would that obviate the possibility?

A. Not obviate the possibility; minimize the possibility for, after all, unless the accounts are in round hundreds and thousands, the permutations and combinations required to make perfect lapping possible are many.

It is very difficult to find four checks exactly equal to \$311.14. The test for lapping with which we were satisfied as the best test was the receipt of the duplicate deposit slips, the question which we exhausted quite thoroughly a few minutes ago.

Q. Yes; I had in mind here the procedure of lapping is to credit in a subsequent period the account which had been actually paid as of the balance-sheet date; and therefore, to that extent, evidence of collection in the subsequent months would not be an indication of the correct balance at the close of the accounting period.

A. My experience is that temporary withholding of that sort is most usually not indulged in with respect to many items. If you trace a number of the deposits for the month or 6 weeks which have elapsed between the balance-sheet date and your audit date, I say if you have traced a number of the deposits in that period, it is

possible that such lapping as existed and was not detected by what we had thought was the most revealing procedure would be disclosed.

Q. Now, at page 8 in the bulletin and again at page 34 under accounts receivable, reference is made to safeguards surrounding the handling of the incoming mail and remittances and of the mailing of monthly statements to customers. What inquiries or tests do you make in this connection and what steps do you take to determine that the system is actually being followed out?

A. The auditor would become familiar, both by observation and inquiry, as to the established procedure during the course of the examination in connection with his test of the observance of established procedure.

The items referred to should receive due attention. Where there is direct confirmation the monthly statements are mailed by the auditor under his direct supervision with return direction to the auditor noted on the envelope.

Otherwise, little besides assurance that the established procedure is conscientiously observed appears practicable. I would say that the mailing of the statements to customers is some assurance that the accounts are authentic, but the assurance would be greater if incoming mail, including undelivered letters, were to be received, opened, and considered by others than those who originally mailed them. Moreover, the mailing of the statements should be by others than those who prepared them and there must be, for the check to be a reliable one, some means of telling that all that should have been mailed were mailed.

Q. Now, looking again at page 34, under accounts receivable, what kind of examination do you understand is meant by the expression relatively limited test as it is used in respect of individual customers' accounts?

A. I venture to guess that if each of the members of the committee which prepared the bulletin were to be asked to answer this question you might have as many different responses as there were persons on the committee.

If the auditor's scrutiny indicated that the established system of internal check and control was actually observed rigorously, that fact would constitute item 1 in the limited test.

Item 2 would consist of aging the accounts and of analyzing most carefully those which were relatively large and/or relatively long past due and/or irregular as to type and nature of allowance.

A relatively limited test would signify that because of the adequacy of the internal check and control less intensive tests would be made than otherwise. Now, I suppose that no member of the committee would agree with me.

Q. Now, turning for the moment to notes receivable, if you should deem in a particular case that it was unnecessary to make confirmation of open accounts, would that control your decision as to whether similar confirmation as to notes receivable arising out of open accounts should be made?

A. Not at all. The notes should be examined, or if out for collection or discounted directly or indirectly, should be confirmed by

the bank or other custodian. There is no reason why notes receivable should not be directly confirmed by correspondence with the makers at least to the same extent as the accounts receivable. My firm does so.

Q. Looking at the bottom of page 33 in the bulletin again——

A. May I add——

Q. Yes.

A. I said my firm does so. One reason is that notes in the hands of the treasurer, which appear to be regular and current, may upon investigation turn out to be forgeries.

Q. Looking at the bottom of page 33, do you consider it desirable to confirm notes receivable under the conditions mentioned in the case of a large installment company with thousands of notes receivable which are controlled by a satisfactory system of internal check?

A. Stressing the satisfactory element, I would say it would be futile and foolish to attempt to make direct confirmation of all of such notes receivable. In general, the suggestion contained in the bulletin appears to be reasonably comprehensive.

Q. You said all of them. Did you mean to imply a test check?

A. Among these notes there may be some relatively large ones as from a group which had purchased or appeared to have purchased in the aggregate items out of line from the normal maximum sale of the enterprise. The temptation might be to try to confirm those as you would ordinary notes receivable.

Q. You referred with some emphasis to the question of a satisfactory internal check. What in your opinion would be a satisfactory system of internal check on notes receivable in such case?

A. I shall hereafter refrain from emphasis.

Q. I didn't mean to unduly emphasize it.

A. The custodian of the notes should not be the person in charge of the customers' records. The cashier or rather note collectors should not be the custodian of the notes or have any access to the records.

The proof that the past due notes were regularly treated by reference to the law department, if there were one, or to the collection department or attorney, and evidence that reports with respect to such items were regularly received and completely pursued and, of course, proof that the notes, under the installment arrangement or otherwise, were being completely paid or at least paid in sufficient volume to show, in terms of statistical experience, that there were no out of line indications.

Q. Would you say that it was customary in the case of a company having a large number of installment notes to have a system of internal audit which would have some system of direct confirmation independent of the usual payment steps?

A. That exists to my knowledge in the case of one such house—the internal auditors check through, as part of their established routine, not only all of, what shall I call it, the interior functioning but also check up on the outside by making personal inquiry among the makers of the notes, the customers.

The EXAMINER. We will take a recess until 2 p. m.

(Whereupon at 12:40 p. m. a recess was had to 2 p. m.)