

**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., Monday, February 20, 1939.

Met, pursuant to adjournment at 9:30 a. m.

Before:

ADRIAN C. HUMPHREYS, Examiner, Securities and Exchange Commission.

Appearances:

JAMES J. CAFFREY, Regional Administrator, New York Office, Securities and Exchange Commission.

H. J. DOWD, Chief Accountant-Investigator, New York Office, Securities and Exchange Commission.

JOHN H. KELLEY, Chief Attorney, New York Office, Securities and Exchange Commission.

WILLIAM W. WERNTZ, Chief Accountant, Securities and Exchange Commission.

ANDREW BARR, Research Accountant, Securities and Exchange Commission.

IRVING J. GALPEER, Senior Attorney, Securities and Exchange Commission.

SYDNEY I. HARRIS, Associate Attorney, Securities and Exchange Commission.

RICHARD J. CORNELL, **FREDERICK M. CURRAN**, and **CHARLES C. FERRALL**, Accountant-Investigators, Securities and Exchange Commission.

CRAVATH DEGERSDORFF, **SWAINE & WOOD**, by **A. I. HENDERSON**, **SAMUEL B. STEWART, JR.**, and **ROBERT D. BLASIER**, of Counsel, Attorneys for Price, Waterhouse & Co.

PROCEEDINGS

Mr. WERNTZ. Mr. Examiner, we are going to start calling this morning as witnesses some representatives of other public accounting firms. These men are appearing at our request in order that the Commission may establish from a representative cross section of the profession what is generally accepted auditing practice and procedure.

In order to obtain a fair sample of opinion, we have invited representatives of both local and national firms in New York, Chicago, and

elsewhere; also, at least one of the witnesses will be one who has worked primarily in the field of accounting education.

Inasmuch as the current months are known to be a very busy part of the year for the public accountants, I want to express the particular appreciation of the Commission to the witnesses for their cooperation.

In addition to their appearance in the hearing, they have spent a considerable amount of time in preparing themselves, and in giving thought to the several items as to which we shall inquire.

To facilitate the proceeding, we have made available to each witness a few days in advance of his testimony, and to counsel, a tentative list of the principal lines of questions.

I would like to call Mr. Samuel Broad as the first of these witnesses.

Whereupon:

SAMUEL J. BROAD

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. Samuel J. Broad, 159 Brite Avenue, Scarsdale, N. Y.

The EXAMINER. Mr. Broad, 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. You understand, sir, I am here as an expert witness, in these investigations.

The EXAMINER. It is the custom of the Commission to remind all witnesses of their constitutional privileges, regardless of the status in which they appear as witnesses.

I. AFFILIATIONS AND BACKGROUND

Q. (By Mr. WERNTZ.) Mr. Broad, will you state your present firm affiliation?

A. I have been connected with Peat, Marwick, Mitchell & Co. since 1916. Since 1926, I have been a partner.

Q. I think you wish to make an opening statement, do you?

A. A little later on, perhaps.

Q. How long have you been in accounting work, Mr. Broad?

A. 25 years.

Q. And have you been with Peat, Marwick all of that time?

A. All except about 3 years. At that time I was employed by a firm of chartered accountants in Canada.

Q. Are you a certified public accountant, Mr. Broad?

A. Yes; New York State, Ohio, Pennsylvania, New Jersey.

Q. And did you have any particular training in accounting prior to coming into the profession?

A. Just the course of examinations that were needed in Canada, leading up to the chartered accountant's certificate, prescribed texts and the laws, and so on.

Q. But there was some professional accounting training in that?

A. Yes.

Q. Educational training in that?

A. Yes.

Q. Would you indicate just roughly the type of firm that Peat, Marwick is at the present time? Is it a very large one, or small one?

A. The firm was organized in New York City 40-odd years ago. We have 29 offices, 25 partners, several hundred members on the staff.

Q. What general type of business do you do?

A. Well, we do certain specialized business, like special departments for banks and system work, and so on, stock brokerage, but most of our work is general industrial work.

Q. Is there any particular type of client that you, that is, type of business that you audit, whether it is general auditing work, or—

A. No.

Q. It is pretty well spread?

A. Pretty well spread, yes.

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

A. I am a member of the American Institute of Accountants, New York State Society of Certified Public Accountants, the Dominion Association of Chartered Accountants in Canada. That is about all.

Q. Have you participated in their professional activities, let us say, in their committee work?

A. I have been active in the Institute for some years past. I have been chairman of the committee on technical information. I was chairman of the committee which prepared in 1935 and 1936 the bulletin, "Examination of Financial Statements."

Presently, I am a member of the special committee on cooperation with the Securities and Exchange Commission, committee on accounting procedure, the special committee on accountants' certificates.

In the New York State Society I have been active in committee work since about 1923. At the present time I am chairman of the committee on publications.

I am a director; member of the committee on cooperation with the Securities and Exchange Commission; member of special committee on auditing practice and procedure.

Q. There is one thing I forgot to ask you. Could you indicate roughly whether your staff increases at the busy season of the year or not?

A. Yes; it increases fairly substantially.

Q. Would you care to go further than that, and give percentages?

A. I couldn't give you the figures. I don't know the figures—probably 50 percent. It might be higher or lower than that.

II. SCOPE OF EXAMINATION OF FINANCIAL STATEMENTS

Q. Now, coming to the problem we have to take up today, would you indicate and distinguish the types of accounting services which you, as public accountants, render, and which lead to, or result in, the certification of financial statements?

A. Well, there is one type of service which confines itself almost entirely to the balance sheet, and which leads to a certificate of the balance sheet only. It only deals with operations in the minor extent

to which it is necessary to deal with them for the purpose of confirming the balance sheet. That is comparatively rare today, I believe.

The other type of service is the type which leads to a report and opinion on the balance sheet and the profit and loss and surplus accounts. I will call it just one general type of service. The work back of it may vary materially in one situation from another. In one case there may be a very minor check of the operations; in another, quite a fairly substantial check, extensive check of the operations, but the extent of that check is determined by the circumstances, all leading up in my mind to the same form of certificate.

It may be in certain cases that we go a little beyond what is required for that certificate and do what we call a detailed audit, but that is rare.

Q. Does the detailed audit, as you understand it, mean that you examine each and every transaction?

A. Pretty much; yes.

Q. Are you familiar with the pamphlet which the Commission has introduced into evidence as its exhibit 117, entitled "Examination of Financial Statements, by Independent Public Accountants"?

This bulletin or pamphlet has been prepared and published by the American Institute of Accountants?

A. Yes; I am. At this point I would like, if you do not mind, to make a preliminary statement of background, about what the answers to the questions may be based upon, on this pamphlet?

Q. I wish you would.

A. The primary purpose of an accountant's examination is to satisfy himself that the financial position and the earnings are fairly stated. All examination work has as its purpose the confirmation of somebody else's expressions of judgment, or statements of fact.

The accountant does this by means of evidence, and I should divide the evidence into three classes generally.

The first class I would call direct evidence, and in that I include documentary evidence, such as agreements, minutes, vouchers, canceled checks, and so on. I also would include direct confirmation, as in the case of bank balances, bank loans, and so forth.

The second class of evidence I class in my own mind as circumstantial evidence. For example, we make a test check of certain of the transactions. On the basis of what we find from that test check, we rely on procedures within the company itself.

An accountant's reliance on internal check and control is based on the belief that if a number of people have part in initiating, carrying through and recording a transaction, the transaction must be a real one.

The third class of evidence, I would call oral evidence: For example, the statements made to an accountant by officers, employees, and others in response to his inquiries.

The auditor has to determine first how much direct evidence he requires, and the extent to which he is entitled to rely on circumstantial evidence. Some things are confirmed directly in every examination. In others, it depends on the extent of the internal check, the strength of the circumstantial evidence, if you will—for example, the confirmation of accounts receivable.

He also must determine how strong the circumstantial evidence must be before he relies on it, and to what extent he is justified in relying on oral statements.

An accountant should not regard his clients with suspicion, unless and until circumstances arise which give grounds for suspicion.

Perhaps I can illustrate what I mean by a simple example. A policeman walks down the street, and as long as he is alert and watchful, he is doing his duty, but if a crime is committed, he does what is immediately necessary, and then he reports it, and a detective is assigned to the case.

Similarly, when suspicious circumstances arise, an auditor steps out of his role of policeman into the role of detective, role of sleuth.

His procedures are changed entirely; his reliance on different classes of evidence is quite different. He requires more direct evidence. The circumstantial evidence must be much stronger, and he may reject oral statements entirely.

Accountants meet varying conditions in business. No two businesses are exactly alike and their personnel varies widely.

For instance, the treasurer may do in one company what the comptroller does in another. The comptroller may do in a second what the chief accountant does in a third. There may or there may not be an internal audit staff.

The size of the concern, the nature of its business, and the extent of the internal check and control determine to a large extent, and within quite wide limits, what an auditor should do before he expresses his published opinions on the financial statement.

Accordingly, you realize that if you asked me for a common denominator of accepted auditing procedures, my answer is just as likely to be the minimum as the maximum. It would not be fair or right to state as the generally accepted practice for all sizes and classes of business what the competent auditor could reasonably do in a comparatively simple case.

I would like to stress that the minimum is just that—a minimum—and in the majority of cases, the auditor goes beyond the minimum.

Uniform standard procedures applicable to all cases could not be laid down by a profession or by any other body. If they could, they could be laid down, and the work could be performed by clerks; instead of being a profession, accounting would be a routine performance.

That is the reason why in New York State now, applicants for the C. P. A. degree are required to have a college degree, why they are required to have years in training before their certificate is given to them.

Auditing can no more be done by rote than can bridges be built from a standard blueprint, or than a lawsuit be tried by formula.

The purpose of any written audit program is to guide, rather than to lead the accountant; to supplement rather than to supplant the exercise of initiative and judgment.

Q. Thank you very much. Did you participate in the preparation of this pamphlet, Mr. Broad?

A. Yes; I was chairman of the committee that prepared it.

Q. And I presume that in your position as chairman you worked considerably on it?

A. I spent most of my time for a summer on it.

Q. What do you think—what in your opinion was the purpose of publishing such a bulletin as this?

A. Well, there was a dual purpose. First, we were trying, and we were hopeful, of informing the public more completely of the purposes of an audit, the limitations of a basis, the basis of an audit, the basis of financial statements generally, and second, to more or less codify what we considered was about the accepted auditing procedure at the time.

Q. Why did you feel that it was necessary to make such a descriptive statement as to the audit, explaining what it is?

A. Well, it had been the practice of the institute for many years past to have such a statement and we felt the old statement was to some extent out of date and it should be brought up to date.

Q. You mean by that that procedures had developed or changed somewhat?

A. Yes; continual evolution of auditing practice.

Q. And now, among the types of services which your firm rendered, does this pamphlet express, generally, the type of examination which you make for the purpose of certifying statements? I believe you referred to only one class.

A. You speak of the type of examination. There is one general type and several examples of that type within it.

Q. Depending upon what?

A. Depending upon the size of the concern, internal check and control, and so forth.

Q. Now, in all of those types of examinations, however, the underlying principles of this bulletin are supposed to be applicable?

A. Right, the underlying principles.

Q. No matter what the particular examination is?

A. That's right.

Q. Do you follow this bulletin in your own practice, Mr. Broad?

A. Yes.

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

A. Yes; all members of the staff, the seniors, particularly. We expect them to carry it along with them.

Q. Referring to your opening statement, you spoke of the question of maximum and minimum. Could you indicate any opinion as to what the procedure in this bulletin is; is that a maximum or a minimum procedure?

A. Well, there are a number of things here that don't apply in some cases. I think perhaps the bulletin itself could answer that better than I could.

Q. Do you have in mind there that if you struck out the things that were inapplicable to a particular case, what was left would be a minimum procedure?

A. Do you mind if I read a couple of sentences from here (referring to "Examination of financial statements")?

Q. Please do.

A. The extent of the examination and of the test-checks—

Q. Would you indicate where you are reading from?

A. A sentence from the end of the first paragraph on page 9:

The extent of the examination and of these test-checks is essentially a matter of judgment which must be exercised by the accountant, based on his experience, on his knowledge of the individual situation, and on the extent of the internal check and control.

At the bottom of that page:

While it is impracticable, as already stated, to set forth in any single program procedures which will fit the widely varying situations which will be encountered, the value of a program as a guide has been so generally recognized that one is presented in the succeeding paragraphs.

I don't know whether that answers your question.

Q. I have asked whether, if you struck out the parts that are inapplicable, because the condition was not present, would your thought be that the remaining procedure was a minimum procedure to be followed?

A. Generally, I would say yes to that. In most cases you do more than is in here.

Q. Does the scope of the examination that you employ agree generally with the examination that would be required by this bulletin in these cases? Do you go beyond it?

A. Generally, I would say we go beyond it.

Q. Did the publication of the bulletin, in your opinion, result in an improvement in audit practice, that is, historically speaking?

A. I would say no, historically. Our attempt was to draw up and put down what was accepted as good practice at that time.

Q. Did you make any attempt to make any particular advances in auditing practice?

A. No; I would say not.

Q. Now, when we come to these next questions, I would like to have you distinguish, if you will, between what we might call satisfactory practice before the recent events in the McKesson & Robbins case, and if there have been any changes since then, just to indicate briefly what you have in mind.

The EXAMINER. Off the record.

(Discussion off the record.)

III. OFFICE METHODS AND STAFF ORGANIZATION AND TRAINING

Q. (By Mr. WERTZ): Mr. Broad, when a client comes to you, do you make any independent investigation of his reputation or credit rating before beginning, or during, the first audit?

A. It would depend on what you call investigation. In quite a number of cases, he is already known to us. He may come to us with an introduction from somebody in whom we have confidence and we would not make any investigation in that case.

Q. Otherwise you would?

A. Well, we attempt only to have clients of good moral standing as well as good financial standing. Just how far we go—we do make inquiries of people we don't know well. Particularly on work we are doing for a registration statement, we make rather extensive investigation.

Q. Both as to reputation and credit rating, or do you rely on your preliminary audit to make the preliminary rating?

A. I would say we make inquiries rather than an investigation.

Q. When you are making these inquiries in proper cases, do you have any particular procedure or do you just inquire where you think you might get some information?

A. I would say it is somewhat haphazard.

Q. Now, from your experience in auditing firms, Mr. Broad, whom would you say exercises the prerogative of appointing auditors to certify the annual reports to stockholders, where the corporation has publicly held securities?

A. In the executive officers.

Q. Executive officers. And under those circumstances, to whom would you say your primary responsibility is?

A. To the corporation as representing the stockholders.

Q. Do you feel any responsibility to the management?

A. Not primarily; no. If we feel any responsibility, it is more to the board of directors than the management, I think.

Q. When you accept one of these engagements, who, on the part of your firm, determines the scope of the audit that is to be made? I am speaking now of the details of the audit.

A. Well, we have what we call a program guide which has a lot of significant items in it. This program guide was drawn up by a committee of four or five partners. It generally depends on the scope. It is only intended as a guide because we expect the supervisor, or the partner at the time to decide to what extent it is applicable to a certain case. It is something like the bulletin only very much more extensive.

Q. Who would consult with the client, would a partner get in on that part of the job, too?

A. As a rule the client wouldn't have very much to say about it.

Q. Whom would you say—who do you say decides or exercises what discretion the client has in determining the scope of the audit?

A. The officer with whom you deal.

Q. Is it the executive officers?

A. The executive officers.

Q. Going to the future, do you think there should be any changes in this process of selecting auditors and fixing the scope of the audit?

A. I wrote a memorandum on that subject, if I may read it.

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

A. I consider—

Q. Before you start, Mr. Broad, when you said executive officers, whom exactly did you mean by that?

A. It would depend upon the corporation. In one corporation it would be the president, in another it might be the treasurer, it might be the comptroller. It depends on the importance of the officers themselves with whom you deal in a particular situation.

Q. Would you say that it was the principal executive officer ordinarily or a subordinate?

A. The principal executive officer in relation to the accountancy. In some cases, the president takes practically no direct interest in the accounts.

Q. In that case it would be the comptroller, perhaps?

A. Comptroller or the treasurer.

Q. Or the treasurer. Thank you. Will you go ahead?

A. I consider the method of appointment of auditors a matter of considerable importance. It is essential that the auditor be truly independent. What he sometimes does now by permission, he should be entitled to do by right.

The Securities Acts place very substantial responsibilities on auditors and also very substantial liabilities. Nowhere, however, do they implement these by giving the auditors any power or authority such as is given by legislation in other countries to enable him most effectively to meet his responsibilities. Reference to the Dominion Companies Act of Canada, for example, will bring out what I have in mind. After defining the duties of auditors, the act proceeds to specify their rights as follows:

Every auditor of a company shall have a right of access at all times to all records, documents, books, accounts, and vouchers of the company, and shall be entitled to require from the directors and officers of the company such information and explanation as may be necessary for the performance of the duties of auditor.

The auditors of a company shall be entitled to attend any meeting of shareholders of the company at which any accounts which have been examined or reported on by them are to be laid before the shareholders for the purpose of making any statement or explanation they desire with respect to the accounts (section 120, Dominion Companies Act).

A suggestion has been made quite often in recent weeks that, in the case of listed companies, at least, auditors should be appointed by the stockholders, rather than by the management and should report to them. This is not a panacea because presumably under our American practice the stockholders, who support the management, either by giving them their proxies, or by voting for their continuance, would probably confirm the auditor of the management's choice. However, if such a procedure resulted in the earlier appointment of auditors, in giving them additional powers, including the right of access to the records at any time, the privilege of being present if they thought it necessary at stockholder's meetings, where the accounts were presented, and if notice of a proposed change of auditors were required to be given to stockholders with a statement as to the reason for the change, undoubtedly the auditors' position would be strengthened.

An alternative, and perhaps preferable, procedure, which has been suggested and which has many of the same advantages, would be to have the auditors selected by the board of directors, as representatives of the stockholders, the appointment to be made at the board meeting succeeding the annual meeting.

The method adopted under the New York banking laws of appointing a committee of directors, other than officers, to take responsibility for audit matters has much to commend it. The auditor's report should be made to the board, or the committee of the board, as representing the stockholders, and the auditors should have the right to appear at board meetings at which their report is presented if special circumstances, in their opinion, warrant it. If their appointment for the succeeding year is not renewed, the board should report to the Commission the reasons for the change, and the auditors should also have the privilege of presenting their side of the case.

Some plan might well be developed by which the auditors would have closer contact with boards of directors in other respects. They might be requested to attend meetings of the board at which matters

relating to the accounts are to be considered. Closer contacts of this nature would, I believe, be advantageous to both the directors and the auditors and would lead to a closer understanding of mutual problems.

Q. You mentioned in there that you thought the auditors should be appointed immediately after the annual meeting, which I assume would be toward the beginning of the year. What did you have in mind exactly there? Would that result in any better type of audit or saving in expense, or what?

A. It would enable some of the work to be done earlier in the year than it is at the present time.

Q. How is that possible, Mr. Broad, when the statements you are preparing are as of the close of the year? Just what part of the work do you do in the interim period?

A. Well, the review of the system of internal control could be done. It might better be done than at the close of the work. Some of the checking of the details can very well be done including the confirmation of accounts receivable, if you are going to do that.

Some procedure with regard to some inventories could be carried out. I think you have a later question on that.

Q. Turning to your own organization, Mr. Broad, do you make any classification of your staff, according to their rank or duties?

A. Yes; juniors, semiseniors, seniors; and supervisors and managers would be put more or less in the same class.

Q. When you take an engagement, how do you determine the staff that is going to work on it? That is, right down the line from the partner on down to the junior.

A. Usually one partner is instrumental in bringing the work to the office. If it is specialized work, it goes to a partner who specializes in that class of work, but generally it goes to the partner who brings it in.

He has a supervisor, or supervisors, who report directly to him and work for him entirely, or almost entirely. As to the choice of senior accountants, the size of the job in relation to the difficulty of the job in relation to the ability of the senior will be considered. If possible, you try to choose a man who knows something about the particular business and had experience in it.

With juniors, generally, the same thing applies, but not to the same extent.

Q. Do you have those assignments permanent for successive audits, or do you change them from time to time?

A. Both.

Q. How do you decide? That is, how do you decide whether you are going to have the same staff or not, leaving out, of course, such things as people leaving the firm, and so on?

A. Well, generally speaking, we prefer to get the same staff back on the work again.

Q. What reasons have you for such policies?

A. We feel that it results in a—generally speaking, in a better audit, more efficient audit. A man instead of having to feel his way at every step is more or less familiar with the problems that are involved.

Q. Are there any disadvantages to such a procedure that you have in mind, but are outweighed by the others?

A. I have a short memorandum on that, perhaps it will be easier to read it.

Q. If you will.

A. There is much to be said on both sides of this question. On the one hand, an auditor who is familiar with an engagement can usually make a better examination, other things being equal; moreover, he will usually operate more efficiently than one who is unfamiliar and has to feel his way at each step.

Too frequent changes involve the element of cost, and there has been a natural reluctance on the part of corporations to agree to a change which increased the cost. In a large engagement it may take 2 or 3 years before an auditor acquires close familiarity with all the accounting ramifications of a business.

At the same time, I recognize there is a serious danger if an auditor gets into a "rut." Between the extremes of changing accountants in charge too frequently and leaving the same accountant too long on the same work, there probably exists a reasonable solution to this question. If work could be spread more evenly throughout the year, it might well be possible to have more than one senior staff member familiar with each engagement so that a plan of alternation could be worked out. For many years we have recognized the desirability of this, but under present conditions have been able to accomplish it only to a limited extent.

Q. When you wish to recruit juniors for your staff, how do you go about that? Where do you get them from? I am speaking now of your permanent staff.

A. Well, the American Institute of Accountants has a plan by which it selects the abler students from a number of colleges and endeavors to place them with accounting firms. We cooperate in that plan. That is one source. The sources, of course, differ in different localities. In some smaller towns the local partner, or manager, will be more familiar with the people there than we are in New York.

Q. What is your practice regarding the temporary staff?

A. Well, for the temporary staff, we require more experience than for a man going on the permanent staff. A man going on the permanent staff—we have to train him for the long pull rather than the short pulls. Temporary staff is for a short pull and he has got to be more or less experienced before he comes to us. We get him, as a rule, through an agency. We get his experience for at least 10 years and check them very closely. We check all gaps in that experience record and we make a routine check to see that all letters of recommendation or inquiry are answered and that we have his full record verified.

Q. Now, do you employ over again? That is, in successive years many men in this type of work?

A. Yes; quite frequently.

Q. Of course, you don't make such a study in their cases except in the interim period?

A. Yes. We have men come back to us 5 or 10 years, year after year.

Q. Would you hazard an opinion as to what those men do in the off-season? That is, do you happen to know?

A. Well, some of them are satisfied to work part of the year. Some of them have outside means. They are probably the minority. Others get similar temporary work in other lines of business. I can't specify. I know that to be a fact.

Q. I just wish to have that brought out. When you are selecting a junior for your permanent staff, do you look for any particular educational or other requirements in him?

A. I could speak more particularly for New York. What I say would not apply all over the country, but in New York, a C. P. A. is required to have a college degree, so we require a junior to have a college degree in the majority of cases before he comes to us.

Q. Does that college degree—do you imply by that that he has had some accounting work in college?

A. I am referring more particularly to an accounting college.

Q. To an accounting college?

A. That is preferred, or there may be a post-graduate accountancy course.

Q. Would you take a man who has not had any accounting experience and train him all the way yourself?

A. We have done that at times. What I have said relates more particularly, I think, to New York State, and since the time when the New York State law was changed.

Q. I see. Now, once you have these men with you, these juniors, on your permanent staff, do you have any regular course of further training for them, or any requirements as to self-education?

A. We would require them to go ahead and study for their C. P. A. degrees. We also have an internal course on auditing procedures, more particularly on the firm's auditing procedures, as distinct from auditing procedures generally. We do not give them a course in accounting. We feel that that can be done better by those who specialize in it.

Q. Who gives that course? Do the partners work in it for you, or do you assign your seniors, or—

A. Partners participate to a minor extent. It is done by an office manager, and specialists in certain types of work.

Q. Will you advance these juniors to a higher rank—let us say, a semisenior, without having received a certificate?

A. Yes.

Q. Do you have any requirements that they get a certificate at any time?

A. Before they can be appointed supervisor or manager, we now have that requirement.

Q. Now, what type of duties do you customarily assign to these juniors, as we have labeled them?

A. It depends to some extent on the junior, the amount of experience he has had. It is mostly routine work, gathering the data on which the senior or partner or supervisor bases his judgment of the situation.

Q. Is any particular knowledge of accounting or business, and so forth, required to assume the duties of a junior, such as you have described?

A. Well, we have what we call a raw junior, who does not have very much of that, but we don't expect very much from him.

Q. I see. Otherwise, you would say that you do?

A. Many of our juniors have had years of experience.

Q. Now, coming to the seniors, where do you get your seniors from? What qualifications do you look for in them?

A. We usually recruit them from the staff.

Q. That is, it is a policy of internal promotion for your seniors?

A. Yes; generally, that is so.

Q. Do you ever take on any seniors on a temporary basis?

A. In recent years we have taken on a number each year on what we call a probation basis, 6 months' probation. If they make good, they may go on the permanent staff.

In New York, to get on that basis, a man, I think, is always required to be a certified public accountant. I think that is a fair statement to make, with some minor exceptions.

Q. I am not quite clear whether you mean that you do not take a senior on a temporary staff unless you—except with the end that he will become a member of the permanent staff.

A. He has to be an exceptional man.

Q. There is no strictly temporary hiring of seniors for short busy periods?

A. Well, that is a general policy. There may be exceptions, but they would be rare, I believe.

Q. Do you expect your seniors to train these juniors—we have seen that they are sometimes raw juniors, and sometimes quite experienced—do you expect a senior, as part of his regular duties, to train them?

A. Yes.

Q. And instruct them in their particular duties, or duties that are particular to a particular job?

A. If they don't know them; yes.

Q. How does he do that? That is a hard question, but can you make an answer to it?

A. Well, it is very seldom that a junior will not know how to reconcile a bank account, but if he doesn't the senior will go through the operations with him.

Q. Outside of this business of training the junior when it is necessary, what sort of duties do you assign to a senior? How would his duties differ from those of the juniors?

A. Well, he is generally responsible for the whole operations of the job. He is in charge of the actual field work. In a large job, he may do—put quite a bit of time on accounting work, as distinct from auditing—supervision of a junior, as I have mentioned; and he is looking out all the time for errors of principle, and incorrect accounting.

Q. You mean principles of accounting?

A. Yes.

Q. I see. Is it one of his duties to satisfy himself that the juniors are actually performing their work that they are supposed to do in a competent manner?

A. Yes.

Q. How does he go about doing that, would you say?

A. Well, usually he is working close to them. He has a general supervision of them automatically. Then, when they get through with

their work, he goes over the papers which they have prepared, and sees whether they have done a workmanlike job or not.

Q. Do you expect him to sample the work they have done by review of the original documents from which they have taken it?

A. I don't think so, generally.

Q. Would your answer be different if the junior in question were a raw junior?

A. Oh, yes.

Q. So that it would depend, perhaps, on the experience of the junior the man is supervising?

A. I think, to some extent, it might.

Q. I see. Now, when the senior is on the job, what does he do while he is down there? Does he just collect the results of the work of the juniors, and review them, or does he have special duties that actually take him into the audit work?

A. Well, now, what kind of a job are you talking about? Shall we take a moderate sized job? The answer would be different for every kind of job in every job you are on, perhaps.

Q. Would you indicate the differences between the various types?

A. In a small job, the senior might do the whole job. Now, that is starting at one extreme—auditing, accounting, and everything else.

In a moderate sized job, he would probably take off the trial balance, do the audit of some of the more important items, like inventory valuations, reserves for depreciation, matters of judgment as distinct from matters of routine; prepare his adjusting entries, prepare the accounts, and draft the statement.

During the course of that, he would do probably a fair amount of the actual auditing work.

In a large job, we might have several seniors, and the top senior might do practically no auditing work. His time largely may be taken up with accounting work.

Q. But in that large job, where you have a senior in that position, would you say the other seniors did some of the work on the audit?

A. Yes.

Q. And, of course, would they be responsible for the juniors, directly?

A. Yes. Well, top seniors are usually responsible for the whole job. We do not relieve them of any responsibility.

Q. But the actual supervision, such as it may be, would be through these underseniors?

A. Assistants.

Q. I see. Do the partners of your firm participate in any way in the actual audit?

A. That would be exceptional.

Q. Do they have any contacts with the clients?

A. Yes.

Q. The partner who is in charge?

A. Yes; that is a regular—we expect the partners to—

Q. Does that contact come during the course of the audit, or at other times?

A. Both.

Q. Do you mean that he does both, or it might come either way?

A. Well, I think in an important job it would probably be both—in the individual job. In other cases, small jobs, he might not get there while the work was in progress at all.

I would like to make this exception: that that applies to points where we have a partner. Some of our branch offices are in charge of a competent manager, and—

Q. Is that manager authorized to sign a certificate for you?

A. Yes.

Q. He would be?

A. He would be. I believe all of our managers are members of the institute, and also certified public accountants. I should say our branch managers are.

Q. Now, when the partner makes his visit to the clients, what does he do—just talk to—whom does he see? Is there any particular routine there?

A. If there is any discussion of the accounts, and he is there for that purpose, he will see the person with whom the accounts are usually discussed—the executive officer that I referred to before.

Q. Would he see anyone else?

A. He would usually meet a few people while he is there, but—

Q. That is, it would not be just an appointment with one particular person, and he comes in and goes out, necessarily?

A. Not necessarily; no.

Q. Although it might be, of course?

A. It might be; yes.

Q. Now, when you obtain a new engagement—I am speaking of “new” in the sense that you have not been connected with this company before—do you expect the staff that is assigned to the job to become generally familiar with the trade, or the industry, before they complete the audit, the first audit?

A. Generally familiar—it is a rather vague term. We expect him to know something about the industry and the trade before he gets through. Of course, he couldn't do work on an inventory of a manufacturing concern without knowing something about—finding out something about the trade or industry, the methods of doing business.

Q. Is that knowledge obtained partially during the course of the audit, or do you expect him to have it while his—

A. It is principally during the course of the audit. We try, if we can, to put a man on an engagement who has had previous experience in that type of work. We can't always do that.

Q. I see. Now, do you expect the juniors, whom you assign for the job, the various jobs, to be reasonably familiar or sufficiently familiar with the type of records and documents that they are going to examine, so as to be able to recognize what might be called significant irregularities?

A. Yes; generally speaking.

Q. How would they get that knowledge?

A. I am not clear whether you are speaking of records or documents.

Q. Take them separately, if you wish.

A. Well, on records, any junior is familiar with the cashbook and journal, and a general ledger, but the variety of cashbooks, from a

small corporation up to a big corporation, with many subsidiary records, is so vast that the best accountant in the world would have to do a little study before he found out the whole system, and how they worked.

We don't expect them to know that in advance. We expect them to become familiar with it. Even a simple item like a cashbook—

Q. And the senior would assist them in understanding that?

A. Yes.

Q. Or someone who has been on the job before that?

A. Yes. Now, as to the documents, we tell a junior accountant what we expect him to see on that document—approvals, and so forth. He is expected to recognize an invoice if he sees one, or a purchase order, or a receiving slip.

Q. And you ask him in the course of his work to note certain items on that?

A. Yes.

Q. Do you expect him to note anything else—any—what we might call again significant irregularities—only in those things, or in anything on the document?

A. We expect him to be alert up to the extent of his experience and ability.

Q. Now, how does he get familiar with the so-called documents? Do you expect him to have that knowledge when he comes to you, from his college course or previous experience?

A. What he gets—from his previous experience, yes; from his college course, it is more of a book knowledge, and he hasn't learned in the hard school of experience. He readily adapts himself to that.

Q. Now, suppose an irregularity is discovered by a junior; do you give any instructions as to what to do?

A. He reports—he is supposed to report it to the man in charge of the work.

Q. And what does he do about it?

A. If he concurs in the junior's thought that there is an irregularity—when you speak of irregularity, I take it you mean some kind of a shortage, some dishonesty, or something of the sort; or what do you mean?

Q. Well, anything that—accounting records or the supporting evidence—anything in that that looks irregular.

A. If it is merely a clerical error, we do not expect him to do very much about it, except take it up.

Q. But if there is—let us call it significant, such as the absence of a name on a check, or the absence of an endorsement on a check, or some changing of date on a check—things of that sort?

A. We would expect him to bring it to the senior's attention, and we would expect the senior to follow it up. If it seemed to be something serious, we would expect the senior to report it to the office.

Q. Would you take those matters up with the client?

A. If they were sufficiently serious to warrant it.

Q. How would that be done? Would you wait until you were pretty sure of your grounds, or would you have the senior in charge go immediately to the client?

A. It would depend on the type of irregularity. If it looked like dishonesty, we would want to make reasonably sure before we made any charges.

Q. Now, would it be fair to say that if an irregularity like that is discovered, that in your own language, the accountant then becomes a detective for certain purposes?

A. Yes, with respect to that purpose; yes, with respect to that item.

Q. That is what you had in mind when you spoke earlier?

A. Yes.

IV. CONDUCT OF THE EXAMINATION

A. INTERNAL CHECK AND CONTROL

Q. Now, when your audit staff goes into a job, a particular engagement, do you expect them to become familiar with the particular concern that is being audited; that is, the plant layout, the operating methods, the general nature of the products, personnel, and so forth?

A. Yes, in a general way, particularly in a manufacturing concern.

Q. How about a chain store? I mean, is it limited to manufacturing concerns?

A. It is more pertinent of manufacturing concerns. The nature of the product in a chain store is not different from that in a retail business. He does not have to become familiar. He presumably is familiar already. The plant layout, of course, doesn't apply to a chain store very much.

Q. Of course not. Now, as to the personnel, do you obtain some sort of an organization chart to indicate the various people who are in control of the accounting functions, or who perform them?

A. There are two or three questions that are indicated here, which I think I could answer perhaps at one time.

Q. If you will, please.

A. By referring to our staff manual. Suggested contents of permanent files: I will read what is suggested should be included there, and I think that answers this question:

Memorandum of information developed from visit through plant; general chart of organization as a whole; detailed chart of accounting department; copy of company's accounting manual; list of principal accounting records maintained, by whom maintained, and sources of entry; list of officers and employees authorized to sign or approve purchase orders and contracts; pay rolls, sales orders, and contracts; credits for goods returned and for allowances; bad debts written off; security transactions; salary advances; vouchers, checks, notes payable, drafts, and acceptances; brief description of duties of each member of internal auditing staff; particulars of the internal auditing program, and instructions.

Now, this is a suggestion and, of course, we expect it to be used with discretion, and the only extent to which it is applicable would be in relation, of course, to the size of the organization. We would not want everybody who is entitled to approve vouchers, or sign checks, but that is generally the nature of the information we expect our men to become acquainted with.

Q. And you require them to be familiar with that, and to keep it up to date? That is, if there are any changes in the personnel, and so forth?

A. Well, generally, yes. I mean, there is no such thing as perfection. We do not expect perfection.

Q. Now, what do you understand to mean—what do you understand this term "internal check and control" to mean?

A. Internal check is used to describe, I think, those methods and procedures within an organization itself that are developed to safeguard the cash, and the other assets of a corporation. It takes the form of mechanical devices and, more particularly, of segregation of duties between different members of an organization's own staff.

It is primarily designed to protect the cash, and to protect the receipt and shipment of goods.

Q. Can it always be used?

A. No.

Q. Why not?

A. Because, for one thing, there is not enough staff to provide the segregation of duties. They may have a one-man bookkeeping concern. Even there, of course, you might have mechanical devices, like a check perforation machine, or something of that kind, but—

Q. Would you indicate just briefly some of the common basic principles or features of such a system; that is, the points which it is particularly designed to guard against?

A. Well, the receipt of merchandise, the shipment of merchandise, the receipt of cash, incoming mail, disbursements, preparing and disbursement of payrolls, the disbursement of funds generally.

Q. Do you distinguish that type of internal audit and control from what is sometimes called the system of internal audit?

A. The system of internal audit is part of the system of internal check and control. It is a part imposed from without, rather than the part that is inherent in the system itself.

Q. Will you explain that just a little further?

A. Well, these other checks I have referred to are developed automatically through the segregation of duties within an organization. One man does one thing, and somebody else does the next step, and the thing goes right through a regular routine. That is automatic within the system. The internal audit staff is not part of the system. It may or may not exist, and if it does exist, it is something imposed from without; not somebody that does any specific duties, but somebody whose duty it is to check what the people who are audited have done, or what entries they have made.

Q. Would you say that the internal audit staff performs very much the same sort of thing that the public accountant does in the annual audit, but does it throughout the year for the internal—

A. No; I would say he is checking transactions, more particularly than assets and liabilities. The outside auditor puts more of his time, I think, on the balance sheet than he does on the transactions.

Q. Would you say that it is the duty of the internal auditor to see that the system is being followed?

A. Very much so, very much so.

Q. Now, turning to page 7 of the bulletin, Mr. Broad, the first paragraph under section 2 there reads as follows:

In determining the nature and extent of his examination, the accountant will necessarily take into consideration, among other things, the purpose of the examination; the amount of detail included in the statements to be covered by his reports; the type of business the accounts of which are to be examined; and the system of internal check and control.

Would you explain briefly the effect of these factors on the scope of his examination?

A. Well, "A" was the purpose of the examination. If an examination, for example, is to detect fraud, it would be a very different type of examination than one that is for the purpose of confirming their financial position, and results of operations—what you might call a fraud audit.

"The amount of detail included in the statements to be covered by his reports": In small concerns, it is not unusual to give a detailed profit and loss account, considerable breakdown of expenses. The accountant takes certain responsibility for that analysis, and has to do sufficient work to justify approving the statements.

Q. May I interject there: Do you mean that if you are going to break down the profit and loss between, say, selling and administrative expenses, it would require a lot of checking that would not be necessary if you had selling and administrative expenses in one item?

A. That's right. "The type of business the accounts of which are to be examined." Well, the difference between an audit of a brokerage concern, say, and a retail store; the difference between a utility and a manufacturing concern—the points of stress are quite different.

Q. What do you mean by points of stress?

A. Well, in one case, the inventory system is the most important item. In another case, the securities are the most important item. In another case, the equipment, maintenance, and repairs, depreciation, have to be considered.

Q. And you think the audit would be adjusted to take particular care of those things that you have called points of stress?

A. Yes; more time would be spent on the more important items.

Q. I see.

A. "D. The system of internal check and control." I find it hard to put that in a few words.

Q. You may use as many as you wish.

A. You come back to my suggestion of internal check and control as circumstantial evidence, and if the circumstantial evidence is stronger, you would do less detail work; if the circumstantial evidence is weaker, you will do more detailed work. Do you want me to go further?

Q. If you care to. There are some other questions a little later on that will perhaps bring it out.

A. I think it will bring it out.

Q. Now, on page 7 and page 10 in this bulletin, it is indicated that this general section 2 is for smaller, moderate sized businesses, and that for large ones, section 3 makes certain modifications.

Would you explain briefly what this phrase, "moderate or small business" means?

That is, how do you test it? Is it assets or number of transactions, or volume of sales, or what?

A. Volume of transactions, perhaps, more than anything else, because I believe the volume of transactions would be related to the size of the staff, or personnel working. The size of the personnel determines the extent to which internal check and control can be applicable.

Q. Would you say that it depends to any extent upon the various—the number of different types of business that the firm does, the

company does? Take a company that has only one particular type of business, as compared to a company that has several.

A. (To the reporter.) Would you read the question, please?
(Question read.)

A. It all relates back to the size of the business, does it not?

Q. Well, I have this in mind: Suppose you have a company that is doing nothing but mining ore, another company which is mining it, smelting it, manufacturing it, and selling it. The aggregate assets may be the same.

A. Well, in the latter case you would probably have a more extensive personnel, doing more operations, and you have a better internal check and control.

Q. I see. You have in mind, then, Mr. Broad, a case something like this: That if a thousand transactions are all similar, you perhaps might have only 1 person in control, whereas, if you spread those over 10 or 15 different types of transactions, you perhaps would have to have several men to handle them, and as a result, you would get more of a system of internal control? Is that what you have in mind there?

A. Well, no; I have in mind more this: You may have a company doing a 10 million dollar business with about 2 people on its accounting staff. You may have another doing a million dollar business with 25 people on its accounting staff. That is just a little exaggerated.

In the latter case, you would have a better system of internal check and control. It would be practical.

In the first place, there would be practically none.

Q. Well, now, where you said you had 25, if each of those controls all of the transactions with respect to a particular business, is that different from where each of the 25 has 1 particular function in respect to all of the business?

A. I think the existence of the segregation of duties would be the determining factor.

Q. It is not the number of people, necessarily?

A. No.

Q. I see.

A. You cannot segregate duties, though, unless you have a sizeable staff.

Q. Yes. Now, on page 9 of this bulletin, Mr. Broad, at the end of the first paragraph, the statement is made that the extent of the examination, and of these test checks, is essentially a matter of judgment, which must be exercised by the accountant, based on his experience, on his knowledge of the individual situation, and the extent of the system of internal check and control. What does that mean—knowledge of the individual situation? How much is the accountant supposed to know about it? When is he supposed to know it?

A. Are you asking the extent of the knowledge, rather than the knowledge?

Q. Well, both; that is, what his knowledge—I think the two are the same, are they not?

A. Well, it is his knowledge of those factors which determine the scope of the examination: For example, the nature of the business,

the extent of the internal check and control. It is his knowledge of those conditions on which he bases his judgment.

Q. Would you expect him to be thoroughly familiar with those factors?

A. Before he does the work?

Q. Well, before he finishes or, let us say, before the first certificate is given?

A. Generally, yes.

Q. Now, what methods do you employ for developing this information in regard to a client's accounting procedure, and system of internal control? How do you go about finding out about those factors?

A. Well, some of them usually have to be determined before the program is made up. Some are made up during the—we try, as far as possible, to determine the information during the course of the interim examination, if we can do interim work.

Q. How do you go about getting it? What do you do?

A. We use a questionnaire, as an aide memoir to the accountant—a certain number of questions, the answers to which we expect him to get.

Some of the answers to some of those questions he will get automatically in the course of his work. He cannot do his work without knowing the answers.

I refer, for example—the question might be, “Who approves credits to customers apart from cash?”

He would know immediately whether it was somebody independent in the credit department, or in the cashier's department, or not.

Other questions he can only obtain the answers to by inquiring from those who know.

Q. Now, is he instructed to get that information from the person who is actually performing the duties, or from the person who is in an administrative capacity, supervising them, or both?

A. To some extent, from both, I think. He might get some from one source, and some from another. I do not think he usually checks one against the other.

Q. Now, you say a good deal of this information is obtained in the regular course of the audit?

A. Yes.

Q. Now, just how do you mean that that is done? Take the example of credit memos.

A. Well, an accountant makes some test check of the credit memos, and the important part of the credit memo work is the supporting papers, and who authorizes and approves them.

If the question is: “Who authorizes and approves them,” he has the answer by looking at the document.

Q. And that, of course, identifies the—

A. That is the job, yes, identify it. There are other cases where an accountant is almost forced to rely on information given to him. For instance, there is an item in our questionnaire: “What control is exercised over the surplus supply of unused checks,” and the normal answer to that question is that the checks are kept under the control of the office manager, and he has a key, and he issues

them as they are required; and, let us say, he tells the accountant, "That is the answer."

The only way the accountant could confirm that, I think, would be by sitting on top of that cupboard, to determine if he lends the key to someone else.

Q. Now, you referred to the use of the questionnaire in your procedure. Would you explain just how you use that questionnaire? That is, what is its purpose? What reliance do you place on it? Do you keep it up to date, and so forth?

A. Well, its purpose is to give a general picture of the system of internal check and control in force. The reliance is not placed on one item, and the lack of reliance is not based on the absence of one particular item. It is a general picture of the system as a whole.

Q. Do you keep them up to date, from time to time, and how—

A. Well, our form provides for columns for revisions from time to time—I think, three revisions. The theory is that they should be done, approximately, once a year, but we don't generally expect to have that theory fulfilled in practice in detail. We don't really expect it or intend it. We expect it to be kept more or less before the accountant all the time.

Q. Does the partner review that questionnaire, or the supervising senior?

A. The supervisor, as a rule, reviews it.

Q. And since he hasn't been out to the plant, if I understand your procedure correctly—

A. He goes out to the plant.

Q. He does?

A. Yes. Our supervisor always goes out to the plant.

Q. What type of questionnaire did you have? That is, what subjects does it cover?

A. It covers the various assets of the balance sheet, and cash receipts and cash payments, cash funds, control of securities, accounts receivable, and so on down the balance sheet. The profit and loss account covers internal control of gross sales, purchases, costs of goods sold, payrolls, and so on.

Q. I see. I am not quite clear on one thing. Do you have one of those made out for each audit for each year, or do you note the changes in the same questionnaire? I wasn't clear on that.

A. Well, our system on these questionnaires is in process of evolution, and has been for 5 to 10 years, and in that course of time, we have developed from something simple to something so elaborate that it became top-heavy, and we developed downwards, and we now are trying out another plan. I will not say we are satisfied yet with what we are doing. The intention is to have these reviewed periodically. I think that is your specific question.

Q. Yes.

A. It is not a new form each year.

Q. It is not a new form?

A. No.

The EXAMINER: Mr. Werntz, we will have a short recess at this time.

(Thereupon, a short recess was taken.)

AFTER RECESS

Q. (By Mr. WERTZ). Mr. Broad, we have been talking about the effect, or the relation, between the system of internal control and the scope of the examination. Suppose that your examination of the system of internal control discloses particular weaknesses, would that require additional work on your part?

A. You mean if there was a weak system in internal check and control it would require more work?

Q. Yes.

A. Yes.

Q. Now, suppose that the internal control was generally quite strong, but showed one particular weakness.

A. I think you would do more work if that was an important element in the audit.

Q. I mean, a significant weakness, of course.

A. Yes, sir.

Q. Could you give some illustrations of situations of that type?

A. I would say, generally, an auditor is not there primarily for the purpose of discovering fraud. You asked for an illustration. I can recall a company which was receiving, it was in the publishing business, which was receiving a lot of cash through the mail and to put it in the vernacular, the system was more or less "wide open." There was nothing, practically nothing the auditor could do after the event to take the place of that weakness at the time.

You couldn't do any more work, you couldn't open the envelopes again and see that the cash was recorded.

Q. You are referring there to a case where a publishing company receives small amounts in the mail?

A. Yes.

Q. A lot of them, and they are abstracted from the envelopes and do not get into the cash funds of the company?

A. Well, they might or might not. There was no reason to believe they weren't, but there wasn't an effective system to check that they were.

Q. Yes. Could you give an illustration of the particular type of weakness which would result, or would be specific enough to cause the use of additional steps in the audit procedure?

A. Where the system of control in the cash was not very good. For example, if the general cash was mingled up with the petty cash funds and the deposits were not made in full receipts of the days, the auditor would reconcile the bank account later, after the end of the year, for the purpose of bringing both the cash and the bank account down to the same date.

Q. Suppose the client should object to your doing that work, what do you do?

A. You are making the audit.

Q. Now, when you go about verifying this system of internal control, does that mean that you both see what the system is and find out whether it is actually operating?

A. Particularly the first, and as far as reasonable, practice the second.

Q. In doing that, do you have to become familiar with all of the paper documents which support the various transactions to the audit of the accounting system?

A. Insofar as the documents are pertinent to the audit; yes.

Q. I am speaking not now of what you do not audit, but do you have to become familiar with the various documents that the company prepares itself so as to know what their flow of system is—or flow of entries is?

A. You asked if you become familiar with the documents. You become familiar with what the documents were.

Q. That's what I mean.

A. Yes, sir.

Q. That is, you know which documents are used for particular purposes and so forth?

A. Yes.

Q. Now, on page 10, paragraph 2 of this bulletin, there appears this statement:

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

What do you understand to mean by that statement?

A. Well, the auditor is primarily interested to confirm that the assets taken on the balance sheet—to satisfy himself that they are there. There may be possibly other assets which should be there, which are not there.

For example, waste material may be sold and the proceeds not accounted for. The corporation should have more assets than it has. This program would not discover that kind of a thing. Petty peculations.

Q. How would the failure to disclose that sort of thing be reflected in the make-up of the profit and loss statement?

A. The income would understate it.

Q. But the net profit in such a case would remain the same?

A. That's right.

Q. It would just be perhaps classification of adjustment, loss by theft instead of cost of goods sold?

A. That's right.

Q. Do you expect the auditor to satisfy himself, however, that the records are in general accurate and truthful?

A. Yes.

Q. And notwithstanding that, you don't attempt to discover these defalcations?

A. That's right.

Q. Insofar as the scope of the audit is concerned here, within that audit you expect your men to be alert to discover irregularities?

A. Yes.

Q. And fraud of any sort?

A. Yes.

Q. Although that is not your principal purpose?

A. No.

Q. Now, speaking generally, what is your practice as to making test samples of records covering certain types of transactions such as,

for example, sales, plant additions, cash disbursements, expenses, and so on?

A. That would depend upon the size of the organization and the extent of the internal check and control. In a small organization on sales, for example, you would perhaps check some of the duplicate invoices to the sales summary and check the sales summary through ledger and perhaps summarize the sales for the year.

Plant additions, you do very much more in a small organization than you would in a big organization. In the big organization you might make minor tests and rely on those tests. In a small organization you might check everything.

Q. Would you say that those are in the nature, let's say, of sample tests, as you sample the flow of transactions?

A. Yes. They are probably more extensive samplings for the plant additions.

Q. Do you feel that such tests, if the results are adequate, are verification of the whole type of transactions of which they are representative?

A. Yes; they are circumstantial evidence on which the auditor is entitled to rely.

Q. Now, those tests aren't conclusive?

A. Not conclusive.

Q. But you do feel it is adequate to rely upon it?

A. From circumstantial evidence.

Q. Yes. And for the purposes of this type of examination, you feel that that type of circumstantial evidence is sufficient?

A. Yes.

B. CASH

Q. I'd like to go into some of the details of the audit program; first, taking cash. The bulletin outlines a procedure here on pages 11 and 12. Do you consider that to be, ordinarily, a maximum or minimum program?

A. For an examination of the size contemplated by this bulletin, I would say it was probably a minimum program.

Q. Would you be able to indicate any steps that you customarily omit or add to these steps?

A. Well, we customarily compare canceled checks with the records for 1 or 2 months or perhaps more in a year, depending upon the size of the organization. We customarily make the same comparison of the deposits between the bank statements and the cash receipts book. We do some vouching of the cash book entries, some scrutiny of it, the cash book, and sometimes in a small organization some of the cash book postings to the general ledger and to the customers' ledger.

I don't think any of those are in here.

Q. When you look at—you say you examine some of the canceled checks. What do you look for on those? I am just trying to get an idea of what you do with those.

A. You look at an occasional endorsement, look at the signature, see whether it looks like a bona fide document. You put a half a dozen checks there on the table and you know whether they look

genuine or not, if you have seen enough of them without scrutinizing them in detail.

Q. Now, on page 33 of the bulletin you will find this statement—well, at that page reference is made to reconciliation of bank accounts by employees independent of the cashier's department. Do you consider that to be an important feature of the system of internal control?

A. That is here related, I think, to—as an exceptional procedure of internal check and control which justifies some reduction from the general program for a moderate-sized company.

Q. If that is done you do not do certain other things that you would ordinarily do?

A. Yes, sir.

Q. But you would regard it as a weakness if that were not done?

A. Decidedly not.

Q. I see. Now, turning back to page 12 again. Under item 8 you find this sentence:

In certain instances such comparison may be extended to include a check of original deposit slips or authenticated copies thereof.

Under what circumstances should that be done, in your opinion?

A. Well, that was intended to catch shortages which could be covered up by manipulations of accounts by carrying over receipts of one day and depositing them the next. It is more particularly a step in the fraud audit. You do it more particularly in cases where the internal check and control was weak. Where the bookkeeper has access to the cash book, for example, and things of that kind. We try to do it in most cases, but it is not an invariable practice by any means.

Q. Now, under that same item 8, in the third line you will find the statement:

Determine that they were composed of bona fide receipts.

What is meant by that word "bona fide," and how do you establish the bona fides of it?

A. I think you get an idea by reading the rest of the sentence:

That no check drawn by the company was deposited in a bank without being deducted, prior to the close of the period, from the balance at the bank on which the check was drawn.

A company draws money on itself, puts it in as a receipt, it would not be a bona fide receipt. An entry like that might be used to cover up a cash shortage, but would not be a bona fide receipt at all. A bona fide receipt, I think, was intended to mean monies received from customers.

Q. Does it mean that you establish the customers or what; or isn't that the intention?

A. That is not the intention.

Q. Is that the only thing you have in mind by the use of the term "bona fide" there, or are there some other things you look for?

A. I think the kind of check this contemplates is that the accountant will take the records and the deposit slips, particularly the checks, and see that those checks are of the same amount as the checks entered in the cash book for that date.

Q. Now, let's look at the general cash for a moment. Is it customary and proper, in your opinion, to include in cash amounts due from foreign banks and from private bankers?

A. From foreign banks, yes; unless there are exchange restrictions. If the amount was unusually large, I think I would want to show it up separately, probably, but ordinarily that is not considered necessary.

Q. What procedure do you follow in determining the existence of such things as exchange restrictions?

A. In most countries where there are exchange restrictions, it is common knowledge.

Q. Do you make any test independent of what you may happen to know? That is, sometimes they change rather rapidly. How do you satisfy yourselves that your common knowledge is the latest thing on the subject?

A. Well, the quotations in the press usually will give me an indication as to whether there is a restriction or not and you will always look up the quotation to get the rates of conversion of foreign currency.

Q. How do you determine that a particular depository is a bank or banker, as the case may be? That is, you have quite a detailed program of cash here. How do you determine that feature?

A. Well, the fact that the client is depositing and withdrawing monies regularly is one indication. I think if the amount is not large, as a rule you will accept the letterhead of the bank. It may be a forgery, but I don't think as a rule you investigate it.

Q. What is the evidence that you rely on there and what do you expect to find in such cases to show that the money is coming in and going out?

A. The entries on the company's books, canceled checks, deposits and so on.

Usually an outlying bank will be the recipient of funds collected locally and those funds will be transferred periodically to one of the main bank accounts of the company, and if those funds are coming in, you are pretty well convinced there must be a bank account there.

Q. Do you vary your procedure in the case of foreign banks at all, or private bankers?

A. In private banks, I think today the question of whether the company has a license or whatever it is to do business as a bank, would be determining to some extent. I think that—I haven't, frankly, run across private bankers very much in my own practice.

Q. Would you expect to determine to your own satisfaction that such a license had been issued? Do you do that?

A. I have never done it.

Q. Have you ever had occasion to do it?

A. No.

C. ACCOUNTS AND NOTES RECEIVABLE

Q. Now, let's turn to accounts and notes receivable for a moment. In quite a few cases, in several items you will find that the pamphlet indicates the necessity of making inquiries as to particular matters. Could you describe, briefly, and from what person or persons the necessary information is to be obtained, that is contemplated by that language?

A. Well, certain of the inquiries relate to the credit risk of the company's customer. The possibility of bad debts. You would make those inquiries of the credit department or of a financial officer who was familiar with credits. Certain other inquiries indicated here, I think, relate to the possibility of returned merchandise.

You would make those inquiries, I think, through, probably, the sales department or possibly the credit department. There are inquiries here with regard to goods consigned to customers or agents. That inquiry would usually be combined with the inquiry with regard to the credits, these shipments if they are included in the accounts receivable would be in the receivable ledger, or probably be outstanding items on which you would make inquiries at the time you are going over the accounts to review the possibility of bad debts.

Q. Now, in item 3, the first sentence reads :

Examine the composition of outstanding balances.

What is meant by that? What do you do in that case?

A. I think that relates back to item 1, "Obtain lists of customers' balances open at the end of the period, with the amounts classified according to age."

To have those accounts aged, the composition of the outstanding balances must be determined. That is, if the sales of the months of November and December, or perhaps some unpaid bill for last June—unpaid bill for last June might be a source of question whether it was an allowance or something.

Q. How far back do you trace those balances to determine the age?

A. As far as you need to go to determine the age.

Q. Would that be beyond the current year?

A. As a rule, if the accounts are over a year old, you will just put them down in one column and—

A. And make an appropriate allowance against them?

A. Yes; discuss them in some detail.

Q. Now, in examining the individual accounts to age them, do you expect the general condition of the individual customers to be noted, such as concentration of charges, in latter months or any particular month, the presence or absence of special credits for returns, allowances, the existence of write-offs for bad debts, and so forth?

A. Well, on concentration of sales I think we rely more on the analysis of sales by months in comparison with the previous year. Generally, in answering your question, I would say we expect the accountant to be alert.

Q. Now, at the top of page 15, this sentence appears :

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. It was not so intended.

Q. What was intended there?

A. It is intended to mean that they usually are not confirmed. I don't think that, perhaps, was accomplished very well.

Q. Are you criticizing now the language here which gives the wrong impression?

A. Yes. I know the thoughts in the minds of the people who wrote this at the time of the discussions on it, and I am harking back to that.

Q. Was it they should not be confirmed except under certain circumstances?

A. No; we hoped they would be confirmed more in the future than they had in the past, and we thought that this might encourage that procedure.