

BEFORE THE SECURITIES AND EXCHANGE COMMISSION

In the Matter of McKESSON & ROBBINS, INC.

OFFICES OF THE SECURITIES AND EXCHANGE COMMISSION,
120 Broadway, New York, N. Y., Tuesday, February 21, 1939.

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

PROCEEDINGS

Mr. WERTZ. I will call Mr. Wellington.
Whereupon:

CHARLES OLIVER WELLINGTON

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. Charles Oliver Wellington. Business address or residence?

The EXAMINER. Your residence.

The WITNESS. 21 East Seventy-ninth Street, New York.

The EXAMINER. Mr. Wellington, it is customary in a hearing before the Commission to 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.

I. AFFILIATIONS AND BACKGROUND

Q. (By Mr. WERTZ.) Mr. Wellington, what is your present firm affiliation?

A. Partner, Scovell, Wellington & Co.

Q. How long have you been a partner of that firm?

A. Since 1912.

Q. How long have you been in accounting work?

A. Since 1907.

Q. Would you indicate just briefly what your experience in accounting prior to your connection with the firm was?

A. After finishing college in June 1907, I worked for a few months in a bank and then obtained a position as a junior on the staff of the Eastern Audit Co. in Boston, and was with them for, I believe, about a year and a half, and then went with the firm of Gunn, Richards & Co., Boston office, and left them and went with Mr. Scovell.

The firm at that time was known as Clinton H. Scovell & Co. The name was later changed to Scovell, Wellington & Co.

Q. Did your college work prior to going into the public practice of accounting include education in accounting?

A. Well, I took the only course that was given on accounting at that time. Remember, that was a good many years ago. Professor Cole at that time gave a course in accounting to undergraduates.

Q. You had that?

A. Yes.

Q. Are you a certified public accountant?

A. I am; Massachusetts and New York.

Q. Massachusetts and New York. Would you care to indicate roughly the size of your present firm and the type of business which it conducts? Just roughly.

A. Yes. We have 11 partners and approximately 125 in the permanent staff, and a total of 175, including the temporary staff. We have never specialized in any particular field. The principal difference between our practice and some others is that we do very little public utility work and we do perhaps a larger proportion in manufacturing, but there has not been any restriction or any specialization.

Q. I see. Have you branches in various cities, or are you located here?

A. Yes. In addition to the New York office there are 10 other offices.

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

A. Yes; I am a member of the American Institute of Accountants, New York State Society of Certified Public Accountants, and the Massachusetts Society of Certified Public Accountants.

Q. Have you participated in any of their professional activities, say, their committee work?

A. Yes; I served on several committees in Massachusetts when I lived in Boston, and I have served on several of the New York State Society committees as well as on several committees of the Institute.

Q. Have you done any other work in accounting, publications, or teaching?

A. I have delivered numerous addresses and written articles. I haven't done any official teaching. I have never had any teaching connection with any college or school.

II. SCOPE OF EXAMINATION OF FINANCIAL STATEMENTS

Q. Mr. Wellington, would you indicate and distinguish briefly the types of services which your firm renders or which public accountants render, which lead up to, or result in, certification of financial statements.

A. Well, generally the work that leads to annual reports to stockholders, or to statements for credit purposes, and occasionally special work on which certification is requested of special facts.

Q. Are those what might be called examinations of the financial statements, or are they detailed audits?

A. They are examinations of the financial statements.

Q. And do you ever make a detailed audit?

A. Very rarely. Only for special purposes or where there is either knowledge or fear of a defalcation or something of that sort that requires a detailed check.

Q. On the basis of such an audit, you could render a certificate, however, I presume?

A. It is not customary to render a certificate in connection with a detailed audit. That is usually for a special purpose.

Q. If you had that special purpose in mind and also the other purpose, you could, on the basis of such an audit, prepare a certificate?

A. Yes, sir.

Q. Would you describe briefly the type of service you render in preparing statements for use in connection with the Securities Act of 1933 or the Securities Exchange Act of 1934? Is that the same as this annual audit, or the audit for credit purposes, that you are speaking of?

A. It is similar to the annual audit with some further work to fulfill the requirements of the Securities Exchange Commission as to disclosure of additional information beyond that normally required or called for, plus whatever further examination we think is necessary because of the liability under the Acts.

Q. Did I understand that you feel you give a little more thorough audit in the case of preparation of statements for those two purposes as opposed to the annual audit? I wasn't quite clear as to your answer.

A. It is more in connection with the scope—that is, sometimes the scope is extended slightly, principally to give further information.

Q. Are you familiar with this bulletin prepared and published by the American Institute of Accountants, entitled, "Examination of Financial Statements, by Independent Public Accountants"?

A. Yes.

Q. Did you or any members of your firm participate in its preparation?

A. I was asked to review the draft of it, and made certain suggestions to the committee. I was not a member of the committee.

Q. And you worked in a consulting capacity, let us say.

A. Correct.

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

A. It was to bring down to date the information in a previous bulletin, to explain for the benefit of the profession and the public, with particular reference to credit grantors and others that are accustomed to use accountants' statements, the work of the profession, brought up to practice and procedure that was customary at that time.

Q. That is, to include the advances or changes that had come about since the previous work?

A. That is correct.

Q. Was there in your opinion any hope that you could explain more fully to people using statements what the scope of an ordinary audit was?

A. Yes, there is quite a bit of the introductory material in the booklet that carries out that idea.

Q. Is the examination set out by this bulletin generally the type of examination you follow in preparing annual reports, and statements for the two Acts?

A. It is.

Q. Would you say that the principles of the bulletin are generally applicable to all types and sizes of companies, as to which you have performed such an examination?

A. The bulletin itself makes the distinction between the small and medium sized company, and the large company.

Q. But with the exception of those distinctions or differences in treatment, the principles are the same?

A. Yes.

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

A. Yes.

Q. Would you say as a general thing that this bulletin prescribes a maximum or minimum procedure for an examination?

A. Well, I should say a minimum for some parts, and a maximum for others. I don't believe you can answer that question definitely yes or no.

Q. Could you answer it this way: If you struck out of the bulletin in a particular case those parts which were inapplicable because the condition was not present, then the remainder would be a minimum for a particular examination?

A. Well, I don't regard it as any hard and fast rule. I regard it as a statement as to reasonable requirement, or reasonable method of attacking the individual problems.

Q. Could you compare, generally speaking, the scope of examination as set forth in that bulletin with what you follow in your practice? That is, do you go beyond it?

A. Beyond it in certain particulars, and possibly in less detail in others, all depending on the individual case. I might say generally that I think it is a good, fair statement as to the average case.

III. OFFICE METHODS AND STAFF ORGANIZATION AND TRAINING

Q. I see. Now, in the questions which will follow, I would like to have you distinguish, if you will, between what your practice was prior to the recent proceedings in the McKesson & Robbins case, and if there have been changes, since, just to indicate what they are.

When you are approached, or approach a new client, do you make any independent investigation of his reputation or credit rating?

A. I don't recall any cases where we have made independent check, because a new client comes in from some source, usually from some other client, or some friend, so that we do know of our own knowledge, without independent investigation, in practically every case.

Q. Well, in those cases where you haven't got a reference which you feel is reliable, what would you do?

A. Well, an answer would be really theoretical, because I do not recall any such case.

Q. I see.

A. But I assume that I would inquire from banking connections, or in some other ways of that sort, to determine facts I felt were necessary as to their general standing, the type of people they were.

Q. Now, from your experience as a public auditor, Mr. Wellington, who would you say exercises the prerogative of appointing auditors to certify annual reports of corporations whose stock is publicly held?

A. I think it depends on the individual company; in some few cases the stockholders; in some, the directors; in some, the presidents; in some, even the comptroller or the treasurer.

Q. Could you make an indication as to the frequency with which those various situations are found?

A. I can say generally one or more of the executive officers.

Q. Ordinarily, the chief executive officer?

A. Generally, yes.

Q. To whom would you say your primary responsibility for your work runs?

A. To the directors.

Q. To the directors as individuals?

A. Certainly not—the directors as representing the stockholders.

Q. As representing the stockholders?

A. Yes.

Q. Would you say you had any responsibility to the management?

A. We certainly have responsibility to the management, to set forth the facts as we find them, and to report to the management anything that we feel should be brought to their attention.

Q. But you think that your primary responsibility is to the stockholders?

A. That is right.

Q. Through the board of directors?

A. That is correct.

Mr. HENDERSON. Are you using management in the sense of officers, as distinguished from directors?

Mr. WERTZ. Yes; management meaning the officers.

Mr. HENDERSON. Were you using it in the same way, Mr. Wellington?

The WITNESS. Yes; I had in mind the officers.

Q. When you accept an engagement, let us say a first engagement, by what representative of your firm is the scope of the audit to be made determined?

A. One of the partners.

Q. One of the partners handles that personally?

A. Unless it happens to be an office where there is a manager and no partner.

Q. In that case, the manager would do that?

A. Yes; although, if the engagement is a large one, it would be referred to one of the partners.

Q. I see. Now, do you reexamine that at intervals thereafter; that is, do you reexamine the scope to see if it has been satisfactory?

A. Yes.

Q. Is that done annually, if you are making an annual audit?

A. Yes.

Q. You might say it is done in connection with each examination that you make?

A. And sometimes an extra review, in the summer, or some period when we are not so busy; sometimes an additional review of comparative scope and procedure in different pieces of work.

Q. From your experience as an auditor, who would you say decides such questions on the part of the client, as to the scope of the audit?

A. In the large companies, the comptroller, or treasurer, or chief accounting officer; occasionally, the president.

Q. Now, looking to the future, do you think that there should be any change in the method of selecting auditors and fixing the scope of the audit to be made?

A. Yes; I think the appointment should be by some other people than those who are being examined, and the appointment should be made at the beginning of the year.

Q. How would that help your work?

A. It would help in planning the work, and also help in making test checks at various times during the year that are most convenient, or likely to be most effective.

Q. What other body would you think it preferable to have appoint the auditors?

A. If there was any one body, I think a committee of directors, the majority of which were not officers. That, I believe, would be the more general plan. I have no objection to the plan of appointment by stockholders, but in the average case, I doubt if it is very effective.

Q. Now, turning to your own firm, Mr. Wellington, do you make any classification of the men on your staff as between, say, seniors and juniors?

A. Yes.

Q. What would that classification be?

A. Generally, supervisors, seniors, semiseniors, and juniors.

Q. And, of course, partners at the top?

A. Yes.

Q. Now, when you accept an engagement, how do you determine which of that staff is to work on the particular engagement? Do you follow any particular procedure in that connection?

A. It depends on the size and complexity of the job.

Q. Would you expand that just a little?

A. Well, as to whether the company is very large, or comparatively small; whether it has merely the one office, or whether there are various branches—that is, branch plants or branch offices in which some examination has to be made; and the type of business—whether it is comparatively simple, or has many products; the way in which the business is done, from the standpoint of both manufacturing and distribution.

Q. How would that determine your choice of staff? Do you mean that you would try to find those members of your staff which were most adapted to that sort of work?

A. The men who were most experienced would, of course, be assigned to the most complicated engagements.

Q. Would you attempt to assign to an engagement a man who has had, say, a similar engagement, or simply a man who has had the broadest experience?

A. Usually the broadest experience. Experience in a similar industry has some advantages and some disadvantages.

Q. That is what I wanted to bring out.

A. Yes.

Q. Now, who would you say, Mr. Wellington, has the authority to select that staff? Is it a partner or an office manager, or—

A. It usually is a partner.

Q. Now, once you have selected the staff for a particular audit, do you make those assignments permanent for successive audits?

A. We endeavor to rotate; that is, to make changes every few years.

Q. Is that a change in all of the personnel, or particular parts of it?

A. Preferably, parts of it, each year; that is, try to have a certain amount of change each year.

Q. Would the partners change?

A. Not usually.

Q. Would the supervisor?

A. Preferably every 3 or 4 years; not every year.

Q. (By Mr. WERTZ) How about the juniors?

A. The juniors, some every year, preferably.

Q. Are those changes among the juniors and seniors due to difficulty of allocating staff assignments, or intention to rotate the juniors?

A. Well, where we can persuade the client to make a change we initiate it ourselves. We find considerable difficulty with clients.

Q. I had in mind this: With your juniors there are lots of staff assignments. Now, do you intentionally try to rotate them, or do they get rotated because of the number of assignments coming in at a particular time?

A. Both factors influence changes, but we do consciously intend to rotate men if we can do so. That, of course, is an advantage for the men as well as the client.

Q. What reasons underlie your policy in that respect, Mr. Wellington?

A. As I just stated, the better training for the men, and bringing a fresh viewpoint to the features of the work that each man handles.

Q. Are there any objections and difficulties with it other than the objection on the part of the client, perhaps?

A. Well, the men don't like too frequent shifting.

Q. Why is that?

A. They get accustomed to certain work and, of course, it is easier for a man to tackle the same piece of work the second or third year.

Q. Now, when you are recruiting, let's say, juniors for your permanent staff, what procedure do you follow? How do you do that?

A. We have been in touch with a number of colleges and schools, that have graduates, either recent graduates or some out several years that are interested in public accounting. We get a good many, I might say the majority of our men, through that source. Others

write in or call at the office and we keep a list of those who have been in touch with us who seem suitable, and then when the opportunity comes to take on men, we work from that list.

Q. Now, do you look for any particular type of training or experience as a general matter in possible juniors?

A. He should have had, if possible, some training in actually doing bookkeeping and accounting work in addition to his studies.

A man is rarely suitable material unless he has done a certain amount of reading and studying, either formal through a school or by himself—by proper reading of accounting texts at home.

Q. Do you require one or the other of those, or both?

A. We have no rigid rules, but that is the general policy.

Q. You attempt to find a man who will meet those conditions?

A. If a man is going to succeed, he has to realize that he must spend a lot of time in preparing himself.

Q. Once they have come under your staff, do you have any requirements as to further education, or self-education such as reading or taking courses?

A. We have no formal fixed rule, but we urge the men, encourage them, to continue with their reading and studying, preparing, of course, for the certified public accountant examination at the proper time, and to improve their own ability and experience through reading.

Q. Do the partners participate in any formal program of discussion or education of the juniors?

A. We have staff conferences which include not only juniors, but the other men on the staff at which we take up various technical matters.

Q. Do you require the obtaining of the certified public accountant certificate as a prerequisite for promotion or advancement with your firm?

A. We have no fixed rule, but that would generally be our policy. That is, we would always encourage them to prepare and pass the examination and get the certificate.

Q. Now, can you indicate briefly any differences in your methods of selecting juniors for your permanent staff from selection for your temporary staff? How do you get those?

A. We haven't a hard and fast distinction. A man may be taken on as a temporary man, and if he proves himself to be exceptionally good, he would be kept permanently.

Q. Do you look for any different qualifications in a temporary employee of that sort?

A. No.

Q. For the peak season, I mean.

A. No.

Q. How would you describe, briefly, the duties which you customarily assign to juniors? What sort of duties are turned over to them?

A. The more routine work such as footing and checking, vouching checks or invoices, aging accounts receivable, making various analyses. Any work that can be done in sufficient volume so that it can be somewhat standardized and turned over to a man to do who can report back the result of what he has done so that it can be checked by a senior.

Q. Would you say that a knowledge of accounting principles was required to satisfactorily perform the duties of a junior?

A. Generally; yes.

Q. Now, as to your seniors. Generally speaking, where do you obtain your seniors from?

A. We have had very poor luck in bringing them from the outside. Occasionally we can employ a man who has had experience and training with some other firms, and who is successful, but by and large we have to grow them ourselves.

Q. What would you say were the types of duties that you assign to seniors as distinguished from juniors?

A. Well, a senior has general charge of the engagement, and not only checks the work of the juniors, but himself undertakes the necessary test and examination of various features of the work which come down finally to the preparation of the statements and the draft of the report.

Q. Do you consider it one of his duties to train the juniors under him?

A. Yes, indeed.

Q. How detailed is that training supposed to be?

A. He encourages the juniors to ask questions and he explains to them not only what they should do, but why they should do it and the significance of what they are doing, to whatever extent is necessary. Of course, many of the juniors have a very good idea as to why they are doing things and what they are looking for, but the senior is supposed, not only for the general good of the men, but for that particular engagement, to explain and supervise so that they will get the maximum benefit of the work they are doing.

Q. You expect him to satisfy himself and thus satisfy you that the juniors are satisfactorily performing their work?

A. That seems to me a very obvious duty. Otherwise, he couldn't do an effective job in supervising the particular engagement. He must satisfy himself that they have done their work effectively.

Q. How would he do that?

A. By going over the working papers, asking questions, seeing that they had taken the various steps.

Q. Would he sample their original work to see whether they had done a good job? That is, whether their working papers included the information they should?

A. Yes, indeed.

Q. Do the partners in your firm participate in the field work?

A. Yes.

Q. To what extent do they participate?

A. Well, they participate in going over the program with the senior or supervisor in charge of the engagement, and usually have some discussion with the client at one or more times when the engagement is going on and then, of course, in reviewing the final working papers and report with the senior.

Q. You say they would go down and see the client during the course of the audit?

A. That would be true in all of the larger engagements. It wouldn't necessarily be true in every small engagement.

Q. Whom would they see when they went down?

A. Depending upon the company. It might be the president, it might be the treasurer, it might be the comptroller.

Q. Would they just see the one person or—

A. Usually it would be more than one.

Q. Would they circulate through the office and watch their own men working and all?

A. To some extent.

Q. But not as a regular thing?

A. Not as a regular practice; no.

Q. When you take a new engagement, do you expect your staff that you assign to the engagement, to become generally familiar with the particular trade or industry in which the business falls? At least, prior to the completion of the first audit?

A. Generally; yes. I don't know how you define "familiar."

Q. Would you indicate what you expect them to know?

A. They must know how the business is done, the general type of products manufactured or sold, and the usual channels of distribution, and general sources of supply of the principal raw materials.

Q. And you expect your juniors to be sufficiently familiar with the type of records and documents which they are apt to come in contact with in order to be able to recognize what we might call significant irregularities?

A. Yes, sir.

Q. How would you expect them to get that training or knowledge?

A. Well, they would get that in the first instance through their reading and studying. In that way they would know the kind of things they should look for.

Q. Is it one of the senior's duties to see to it that they do understand the documents they will be required to examine?

A. Yes.

Q. Would you say that you expect your staff to be alert to report irregularities that they come across in the course of their work?

A. Certainly.

Q. Now, do you give them instructions as to what is to be done in such cases?

A. Matters of that sort are discussed at these staff conferences I mentioned, and the usual practice is for the junior, if he discovers something, to report to the senior and the senior would usually make such further investigation as he thinks is necessary to establish the fact as to whether it is a serious matter or whether it is merely a failure of the junior to appreciate the facts and that if there is really anything out of the way, the senior would take it up with the partner.

Q. At what point in the proceeding would you take it up with the client?

A. Usually after discussion with the partner. If the engagement was a long way from headquarters, it might be discussed merely over the telephone and the senior would then be told to take it up with the client.

Q. Suppose it is an irregularity, we'll say, which the senior doesn't feel is sufficiently important to take up with the partner. What is done in that case?

A. Well, I am not quite sure as to the type of irregularities you mean. You mean one involving a defalcation or one involving merely errors in bookkeeping?

Q. Suppose you indicate each of them.

A. In the case of a defalcation it would be taken up with the partner. And if it was merely errors in bookkeeping it would be taken up by the senior with the chief accountant.

Q. Suppose you came across a lot of checks that weren't endorsed that should have been.

A. That would be taken up, in the first place, with the senior to determine whether they had any real significance, and if he was satisfied that lack of endorsement was merely due to errors on the part of the people who had handled the checks or on the part of the bank, he then would take it up with the chief accountant. If there was any evidence that there might be some defalcation or some real trouble, then he would make a complete record of it and then start tracing it down.

IV. CONDUCT OF THE EXAMINATION

A. INTERNAL CHECK AND CONTROL

Q. I see. To what extent do you require the members of your staff assigned to a particular engagement to become familiar with the concern that is being audited? That is, its plant layout or operating matters, nature of its products, I think you have answered that point, and the character of the personnel involved as distinguished from the general industry?

A. We have no fixed requirements, but we would expect that any competent and experienced men would, as in the regular conduct of their work, gain a general impression of the people and of the business carried on.

Q. Do you obtain, or prepare, an organization chart, or its equivalent which shows the duties of the various people in the office, particularly those engaged in accounting work; the lines of control?

A. We don't prepare a formal chart but we do put in what we call our permanent file a rather detailed analysis of the various positions and the relation between them as far as the accounting is concerned.

Q. Is that analysis kept up to date annually?

A. Yes.

Q. Is that a requirement, that it be kept up to date?

A. This applies to the larger engagements. We don't attempt to go into that detail in the smaller engagements.

Q. What do you understand to be meant by the term "internal check and control"? Could you indicate just roughly what it is and what some of the basic features are?

A. It is generally a plan whereby one department checks the work of another or one man checks the work of another, if the company is not large enough to have departments; for example, the handling of cash by different people than those who make the records of the checks.

Q. Would you say there is any difference between a system of internal check and control and a system of internal audit?

A. Yes. Internal audit would imply that there was an actual staff of one or more people who did auditing separate from the keeping of the records.

Q. Would you say that such a staff is part of the system of internal check and control?

A. There should be a system of internal check and control in a properly laid out accounting plan, whether there are or are not internal audits. The job of the internal auditor is to check as to the effectiveness of that control, and then make certain audit checks of the details of the different departments.

Q. Could you indicate briefly what the purpose of such a system is? Why do you have a system of internal check and control?

A. To insure accuracy and honesty, to whatever extent that can be insured by the system, and the division of responsibility.

Q. By division of responsibility, do you mean segregation of duties, too?

A. I do, yes.

Q. In different persons?

A. That is right.

Q. Now, if you will turn to page 7 in this bulletin, Mr. Wellington, under section II, you will find a statement that the nature and extent of the examination depends on the purpose of the examination, the amount of detail included in the statements to be covered by the report, 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 each of these factors on the scope of the examination which you would conduct?

A. Well, it would depend as to whether the examination was for purposes of a credit statement, or an annual report to stockholders, or an engagement to make a special report on a certain section of the work, or for a particular purpose.

Q. Well, let us take here, the report that you would file with the Securities and Exchange Commission, under one of those two acts that we have mentioned. How would these factors bear upon the scope of the examination?

A. Well, if the company has a good system of internal check, the amount of detail the auditor needs to cover is much less than in a case where there is a poor or nonexistent system of internal check.

Q. What is meant by the type of business the accounts of which are examined?

A. Well, some businesses have a few transactions in comparatively large amounts; other businesses have numerous, thousands of, transactions of comparatively small amounts.

Q. How would that affect the scope of the audit?

A. To check all of the transactions in a business with a large amount of detail would obviously cost more than the value of the work to the client, so that you would expect in a case of that sort, that the company itself would have developed a proper system of internal check, and you would see that that system of internal check was in effect and was working.

Q. Do you mean to imply that where there were a few large transactions, you would examine all of them, in the ordinary course?

A. You would examine more of them, relatively, than you would in a case where there were many thousands.

Q. Now, at pages 7 and 10, it is indicated that section II is for small or moderate sized business, and that for large ones the modifications of section III should be made.

Could you indicate what in your opinion is the criterion used for distinguishing between a small and large business in that sense?

A. Well, the best general measures would be the sales and the volume of transactions.

Q. That is, you might class as a large business one that had a large—say, \$10,000,000 of small transactions possibly, as a small business, for this purpose, ones that had \$10,000,000, with only a few large transactions.

A. Well, I should think a business that had sales volume of \$10,000,000 was beyond the small stage. It might be classed as large.

Q. No matter how few transactions were involved?

A. Yes.

Q. But when you get down to the lower sales figures that criterion becomes significant?

A. That is correct.

Q. Would it make any difference whether the business was engaged in only one particular line, or whether it involved several different types of business?

A. You could probably cover more transactions at a reasonable cost if there were only one line than if there are a number of different lines.

Q. Why would that be?

A. Because of the simplicity of the work.

Q. That is, by testing a percentage of the transactions where there is only one type of business, you could ascertain facts as to all of them, whereas, in the other type of business, you would have to test some in each of the lines; is that what you have in mind?

A. If the system is properly set up, with several lines of business, you would have on the records themselves each department or each division kept separately, so that after you would establish the fact that the division between them was substantially accurate, then you would not need to make very many test checks of any one of those divisions.

If there was only one division of the business, you could, of course, apply certain tests to that whole business. You probably could go into more detail effectively or economically, you might say, if there was only the one than if there were perhaps five divisions.

Q. Now, at page 9, in the bulletin, it is indicated in the last sentence of the first paragraph 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 on the extent of internal check and control.

Now, what is your understanding as to the extent of such knowledge of the situation which the accountant should have before completing his first examination?

A. Well, he should have a good general knowledge as to the way the business is done, as I believe I mentioned before—the general

sources of the principal raw materials, the method of distributing the various products, that is, whether direct or through jobbers or agents; he would have a general knowledge of the organization of the business; he would have a general opinion as to the personnel with which he had come in contact; he would have a good knowledge as to the internal check, that is, the way it was developed, and the effectiveness with which it was handled; and he would, of course, have general impressions of the business in connection with his work.

Q. When you said a good knowledge of the system of internal check and control, did you mean to emphasize that as a particularly important point?

A. Yes; because that very definitely affects the extent to which he needs to make tests to satisfy himself.

Q. How do you develop information in respect to the client's accounting procedure in a system of internal check and control? Do you follow any particular method there?

A. Merely inquiry. Perhaps I don't get the purpose of your question.

Q. Do you use a questionnaire, let us say?

A. No; no formal questionnaire.

Q. Do you have any instructions as to what the audit staff is to ask, or do you leave that up to the senior in charge?

A. That is left to the senior.

Q. How does the partner review the system of internal control?

A. In the larger engagements, as I have mentioned, there is put in the permanent file an outline of the method of internal check that the client has developed, and that is in some detail, as a result of the inquiries that have been made, and that is reviewed by the partner with the senior.

Q. Would you say, then, that the senior in charge develops the information to his own satisfaction, and prepares a memorandum on it, which is then reviewed by the partner?

A. That is correct.

Q. Is that memorandum kept up to date from year to year?

A. Yes.

Q. Is it a requirement that there be such a memorandum in the permanent file?

A. On the larger engagements; yes.

Q. Do you have any particular procedure which you follow in order to satisfy yourself that this system of internal check and control is actually being followed by the clients, or is that part of the previous study?

A. Well, that is a very important part of each audit, to see that the system of internal check actually is working.

Q. Does that depend wholly upon inquiry of the employees, or officers of the client?

A. Inquiry plus observation.

Q. What do you mean by observation there?

A. Well, to see that the handling of the mail or the handling of the postings or the routine work—I don't mean by that that we have one of our men stand over the various clerks, but in general observation of the office. You have a man who has his eyes open, who will

see as to whether the general routine that he understands to be in force is being carried out. That would be general, rather than specific.

Q. Can any of that internal system be determined from the documents which you do examine, such as credit memoranda on return sales, say, from the initials on it?

A. Usually documents bear initials, or some record as to which people have passed on them, and that would indicate how many different people were approving different documents.

Q. Do you expect your staff to look for such evidence?

A. Certainly.

Q. Now, when you make these inquiries, do you inquire of the administrative officers, the supervisors of the people who are performing the individual duties or from the people who do the actual work themselves?

A. Both.

Q. Do you mean both in each case?

A. Generally, yes. We would interview, or, rather, ask questions of certain clerks and certain heads of departments. There is no regular procedure on that.

Q. You leave that pretty much up to the seniors?

A. Yes.

Q. As to what they are to do?

A. As to how far down the line, or how many people need to be interviewed.

Q. Now, suppose your study of the system of internal check and control discloses certain weaknesses in it, would those require additional steps in your audit program?

A. Usually, yes.

Q. Could you give an illustration of that, say, of a weakness, and what additional steps it might require?

A. Well, credits—that is, allowances to customers, if they appear to be handled without proper approval of someone who didn't handle cash or customers' accounts—we might have to make a list of those credits, and take them up with one of the principal officers, such as the president or treasurer, or possibly the sales manager, to be sure that they had proper approval, if there wasn't evidence in the record of the way that the accounts were handled, that they had been approved, to be sure that items weren't being put there to cover up shortages.

Q. Would you discuss the nature and scope of any additional work to be done with the company itself, or with the officers?

A. Yes.

Q. What would you do if the company objected to your doing that additional work? I am speaking now, of course, of a significant case, not one that you felt was immaterial.

A. Well, if it was sufficiently serious, we would refuse to go ahead, but I don't recollect any such case in my own experience, because the work required would be what we thought was necessary, and we would expect to persuade the necessary officer or officers of the company that it was necessary.

Q. Would you go ahead and do it at your own expense, if necessary?

A. Yes; assuming it was reasonable.

Q. Suppose it was not reasonable.

A. There we would have to—if it was unreasonable in amount, and they would not pay for it—we would have to stop the engagement.

Q. I see.

A. That is theoretical, because I don't remember any such occasion.

Q. You would say as a matter of practice, that you would iron those difficulties out with the clients, and there would be an adjustment in the fee, if it was a fixed fee, and so forth?

A. Yes; that is right.

Q. Would you say that when you have completed the verification of the existence and working of the system of internal check and control, that there should result on the part of the auditor a knowledge, a thorough knowledge of the accounting system followed by the clients, including a knowledge of the records or internal records which support the various transactions?

A. Thorough as to procedure and plan and method, not thorough as to having seen every document and every piece of paper.

Q. Would he have seen every type of document?

A. Yes; that was significant in bearing on the features of the examinations that lead up to the financial statements.

Q. That is, you would expect him perhaps to know what company document went with the—went into a voucher jacket, we will say?

A. Yes.

Q. And where those came from, and who was supposed to make them out, and initial them, and so forth?

A. That is correct.

Q. Would you say that an examination of the character that we are discussing should disclose fraud?

A. Not necessarily.

Q. Well, then, will you look at page 10 of the bulletin, and indicate what you feel the second sentence of the second paragraph there means?

That sentence reads:

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.

A. Have you given me the right reference? You said page 10.

Q. Page 10, the second paragraph, the second sentence of that paragraph.

(Discussion off the record.)

A. May I have your question again?

Q. Yes; I would like to have your understanding of what that sentence means, as to the examination we are discussing.

A. It is not customary in the larger companies, or, in fact, with any but very small companies, or very special engagements, for the auditor to make a complete audit, and he satisfies himself by tests, these tests being more or less extensive, to satisfy himself as to the general accuracy of the statements.

Now, obviously, if the full detail is not covered, if there is a shortage which would appear in the period not covered, or in the section of certain records not covered in the tests, there would be no exposure through that method of a shortage, a defalcation.

Q. Well, within the scope of the audit that you performed, do you expect the staff to be alert to discover fraud?

A. Yes.

Q. That is, if they are covering cash for one month, you would expect them to discover things in that that would be disclosed by the examination they made?

A. Yes.

Q. And I think you said that you expected the auditor to be satisfied with the general accuracy and integrity of the records?

A. Yes.

Q. Otherwise, he would do what, if he was not satisfied?

A. He would continue until he was, or report that he couldn't be.

Q. Or possibly discontinue the engagement.

A. Yes.

Q. Now, speaking generally, Mr. Wellington, I think you have said that in this type of examination, you ordinarily make a sample check of certain transactions; that is, you do not examine every transaction, but you examine a sample of them; is that correct?

A. That is correct.

Q. Do you feel that such a test, in an examination of this type, if the results are satisfactory, is adequate to verify the records as a whole?

A. For the purpose of the examination, yes.

Q. Do you feel that such procedures conclusively verify the records?

A. No.

Q. But you think that even though these tests are not conclusive, they nevertheless should be relied upon?

A. For the purpose of the statement.

Mr. WERNTZ. May we have a few minutes recess?

The EXAMINER. Yes.

(Whereupon a short recess was taken.)

AFTER RECESS

B. CASH

Q. (By Mr. WERNTZ.) Now, Mr. Wellington, I would like to go into some of the details of the audit program. I would like first to take the case of cash. Do you consider the cash program that is outlined on pages 11 and 12 of the bulletin to be a maximum or minimum procedure?

A. Based on our own practice, I should say it is a minimum. We do, in general, somewhat more than that.

Q. And could you indicate what steps you take that are not required by that?

A. Well, we usually check the canceled checks and deposits in detail for 1 or 2 additional months of the year, picked at random.

Q. Just pick any month during the year?

A. Yes.

Q. Is there any other step that you perform customarily?

A. That would be the principal difference. That is, extending the amount of detailed checking.

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

A. I think it is relatively unimportant. Assuming that as stated here, these are working funds and that there are many comparatively small funds, presumably, run on an imprest basis where there is a fixed amount, I shouldn't think it was necessary for the auditor to do over what the client's own employees had done as a matter of routine if he was satisfied that the funds were checked up regularly, as a matter of routine.

Q. I think on page 33 that has reference to something else. It says there:

Where the amounts are reconciled periodically by employees independent of the cashier's department.

What I had in mind was this: How important do you consider the fact of independent reconciliation?

A. I think it is very important. It follows along the idea of internal check where one department checks the work of another.

Q. And now, taking the small working funds. If the reconciliation was not made by an independent group, would that change your opinion as to whether you ought to reconcile them yourselves?

A. Yes.

Q. You think, then—pardon me. Would you feel that you had to do the reconciliations yourself?

A. Generally, yes. Depending again on the size and number.

Q. Now, how would you feel as to the general cash funds?

A. We would always reconcile the general bank accounts.

Q. And would you have the same feeling there as to the company's reconciliation being independent of the cashier's department?

A. We would make our own on the general bank accounts.

Q. You wouldn't rely in any case on theirs?

A. No.

Q. You have said in the case of the working funds you think it would be important for the client to have an independent reconciliation. Would you say, as a matter of internal check and control, it would be equally important in the case of the general funds or more important as a feature of the system of internal check?

A. I think they should have the separate reconciliation as part of the internal check of the general funds; yes.

Q. Would you say that would be a point of weakness if they were not independently done?

A. Well, it is a point of weakness as far as the client's organization is concerned. It is not a point of weakness as far as the whole picture is concerned inasmuch as we do that as part of our work. We would certainly advise the client to have it done regularly during the year and not merely depend upon the independent auditors for the only check.

Q. Do you reconcile that bank account for the whole year or just for the end of the year?

A. At the time of our examination.

Q. Wouldn't it be important, as for the other months in the year that it had been reconciled independently by the client?

A. Certainly, from the client's standpoint.

Q. But not from yours?

A. It wouldn't be necessary for the purpose of giving a proper certificate for a financial statement, that is, we would explore the integrity of the final balances at the end of the year.

Q. And you wouldn't be interested in the interim balances, particularly?

A. Only for testing as to accuracy of the work but unless we were making a detailed check on it, we couldn't expect to cover other than the end of the year and these 1 or 2 months during the year that I mentioned where we would make the extra test check.

Q. I see. Now, page 12, in item 8, again the last sentence there reads as follows:

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

Could you indicate under what circumstances that should be done, in your opinion?

A. In our practice it would not be customary to check authenticated deposit slips unless there was some fear of defalcation.

Q. You wouldn't do it as part of your ordinary program?

A. No; because in most cases it would necessitate going to the bank and getting such information from the files of the bank.

Q. Could you do that?

A. It could be done, but it is not customary unless there is some suspicion of a shortage, a defalcation.

Q. Would that be an expensive procedure?

A. It would be reasonably expensive. Not excessively so.

Q. Do you think it—I take it that you think it is not an indispensable procedure, however, in order to furnish satisfactory statements?

A. No.

Q. Now, in the third line of that item 8, Mr. Wellington, the reference is made to bona fide receipts. What is your understanding of the meaning of that term and how do you establish that fact that they are bona fide receipts?

A. They are receipts from the source that is indicated by the cash-receipt records, presumably receipts from customers. That is, those outside the business and the only normal check on that would be to test postings with the customer's account to see that the money that came in was actually credited to the customer's account.

Q. As you understand it, does the term "bona fide" there mean bona fide customer or bona fide receipt or both?

A. It would be both.

Q. Do you make any test to determine whether the customer is bona fide?

A. There would be no check made in the usual course, in the usual examination, other than review of the customer's account to see whether it appeared to be handled in the usual way. I mean, the usual kind of entries as to sales, cash receipts, allowances, adjustments; whatever entries were customary in the business.

Q. And would you accept as a bona fide receipt an indication that a customer apparently, on the books as such, had paid his bill in such and such an amount?

A. Yes.

Q. Now, in your practice, do you customarily include, in cash in banks amounts due from foreign banks and private bankers?

A. Yes.

Q. Do you have in mind any conditions under which that inclusion would be improper?

A. If there is a restriction as to exchange whereby the cash was not available, it might be omitted or shown as a separate item, or at least a footnote to indicate the amount involved and the extent of the restriction.

Q. Do you follow any particular procedure so as to determine the existence or absence of such restrictions?

A. They are generally known. That is, with most of the larger countries where there have been any restrictions, that is a matter of general knowledge.

Q. That is, you would rely on the knowledge of the company and make no independent determination of your own?

A. We would usually know of our own knowledge, outside of that particular engagement. We would, of course, inquire of the proper officers or employees of the company.

Q. Would you consider that factor specifically in each of the foreign countries in which the company had a bank balance?

A. Yes.

Q. And if you weren't sure as to the status, would you then look it up?

A. That's right.

Q. Now, how would you determine that one of these people actually was a bank or a banker? Do you have any procedure for that?

A. We have no regular procedure. We would, of course, in our examination have seen canceled checks and bank statements and we would have a certificate signed by them in verification of the statement at the close of the year or at the time the account was reconciled.

Q. Would you rely on that type of evidence to establish the fact that they were a bank?

A. Yes.

Q. Where do you—why is it you feel justified in relying on that sort of evidence?

A. Well, that is the evidence that you customarily get in connection with a bank statement, or rather with the bank account.

Q. That is, you feel that if the documents that you get from the bank in the form of canceled checks and so forth, are in the form that you have found to be customary in the case of banks, that is sufficient evidence to establish in your mind that it is a bank. Is that a correct statement?

A. Yes; that's correct.

C. ACCOUNTS AND NOTES RECEIVABLE

Q. Now, let us turn to accounts and notes receivable. In items 3, 5, and 6, among others, the pamphlet indicates the necessity of making inquiries as to particular matters. Would you describe briefly how and from what person or persons the necessary information is obtained in those cases? In item 3 it is about the sixth line.

A. Item 3 we would consult with the credit department and also with the treasurer of the company in connection with the larger items. We might in some cases refer to the trade reports that the credit department would usually have as part of their file but generally we would rely on the information that the company had and also, of course, the information disclosed by the accounts them-

selves. That is, whether the customer was generally slow in payment or whether he was generally prompt, and the relation between a particular customer and the customers as a whole.

Q. Would your answer be any different if the amounts were significantly large? Would you make any special verification there?

A. It would be no different, except that naturally a large account would be relatively more important and therefore would be given more time.

Q. How about item 5, Mr. Wellington, the first word and the first two words in the third sentence refer to inquiries.

A. The question of trade discounts and cash discounts should be discussed not only with the credit department but with someone in the sales department to indicate who would, presumably, have knowledge as to what was being allowed either in an individual case or generally to a certain type of trade.

On item 6, which is the third item that you spoke of, we would obtain information from the credit department, possibly from the sales department, as to the general practice of the company—about whether they do or do not ship goods on consignment, or to agents; and then, we will also get a statement from the treasurer, indicating what goods, to his knowledge, were on consignment, either way; that is, with customers or agents, or with the company itself, belonging to vendors.

Q. Now, back to item 3 again, what is your understanding of the sentence "Examine the composition of outstanding balances"?

A. It is a case of what we call aging; that is, due for sales made in December, sales made in November or October, or any earlier months that remain unpaid at the date of the examination.

Q. Do you expect, in connection with such an examination that the general condition of the accounts be considered; that is, the presence of write-offs for bad debts, returns and claims, concentration of charges in particular months, particularly toward the end of the year?

A. We would expect the men making the composition to review the account, or, at least, review that part of the account that was open at the end of the year. It would not usually cover a review of the earlier months.

Q. Well, suppose you have a flow of transactions: How would you determine what the age of the account was?

A. By actual analysis.

Q. Would that carry you back into the earlier months?

A. It would, for any item that was open.

Q. But you would not expect a general review of the accounts except for the more recent months?

A. That is correct, unless there was some disclosure of something that indicated the necessity for going back.

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

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 confirmation of receivables should ordinarily be made?

A. I don't understand that implication.

Q. What is your understanding?

A. That it is a very good and effective method of not only confirming the validity of the accounts, but also of disclosing an irregularity, if there is one; that is, that is one of the places in which the irregularity might be covered up—in the customers' accounts—so that verification is desirable, but to answer your question, it is not customary.

Q. Would you say that there might be—could you indicate any circumstances under which you think it would be necessary to have confirmation of receivables?

A. Not for purposes of a general statement; that is, an annual report. It might well be necessary in a special examination, and particularly if there was any thought of possible defalcation or shortage. That, of course, would only be done after consultation with the management.

Q. Would your answer be any different if a very large percentage of the receivables were concentrated in a relatively few accounts, as compared to a situation in which they were scattered over a large number of accounts, relatively small amounts in each?

A. I don't think that would necessarily require a decision either yes or no. It might make it more desirable, but it would not require it particularly, as you would have your verification through the analysis of your account and your aging. I don't think size would necessarily decide as to whether you did or did not. In general, I think it is desirable to do it, whether large or small.

Q. Well, looking to the future, would you say that you think it would be feasible to make some sort of confirmation of part or all of accounts receivable?

A. We like to do it, wherever we can persuade the clients to pay for the additional work. I mean, that has been our practice for many years: That independent verification be made wherever reasonably possible.

Q. But, do I understand you correctly that you do not feel it is an essential in this type of examination?

A. No.

Q. Do you find any great reluctance on the part of clients to permit you to confirm receivables?

A. I think it has been growing less year by year. There are two objections that they bring up: one is the disturbing of relationship with customers and the other is the expense.

Q. Could you indicate the relative value, from the point of view of cost, or expense, and as a nature of the check of the different types of confirmation: That is, positive confirmation of as many accounts as you possibly can get, or positive confirmation of a representative sample, including, let us say, all of the larger accounts; and negative confirmation of all accounts?

A. My own preference is for negative confirmation of all, rather than positive confirmation of a few. Of course, positive confirmation of all would be the most complete, and also the most expensive.

Negative confirmation of all, if properly planned, is not particularly expensive, and positive confirmation of the larger ones and tests of the smaller ones, I think, is less satisfactory than negative confirmation of all.

Q. Would you indicate why?

A. What you are endeavoring to discover is any important difference between the customers' records and the records of the clients, and negative confirmation should disclose that.

Q. You think that negative confirmation would bring in just as many answers as the request for a positive confirmation, if there is any error?

A. If there is any error, it should; yes.

Q. Do you find any reluctance on the part of the customers to make such a confirmation or to—

A. No; not generally.

Q. Are there any particular types that you found who will not confirm, or whom you have any great difficulty with?

A. I should not think it was practical in the case of a business dealing with very many individuals, such as—well, a book distributor, for example. There might be 5,000 individual customers at a particular time. I should not think it was practical to send out confirmations of any sort to a list of that kind.

Q. You are assuming that each of them is relatively small in volume?

A. Yes.

Q. Probably small in amount?

A. Yes. My other observation was based on the average manufacturing or trading concern, where the accounts would run into some money.

Q. Now, at one or two places in this bulletin, Mr. Wellington, reference is made to safeguards surrounding the handling of incoming mail, and remittances, and to the mailing of monthly statements to customers.

In this connection, what inquiries, or tests, do you make, if any?

A. We inquire of the clerks or the department that handles the incoming mail, as to what the routine is, and make similar inquiries in the accounts receivable ledger department, and in the cashier's department, and then, in connection with the work, observe the way in which the mail is handled.

Q. Do you make any tests or examination to see whether statements are actually mailed to customers?

A. I don't know of any such examination ever having been made.

Q. You have never made one in your practice?

A. Where we verify customers' accounts, we regard that, of course, as an essential part of our work. That is, we see to it that we ourselves mail the statements, or mail the requests for confirmations, but as far as checking what the client's own organization does, we have never covered that, except by inquiry.

Q. If you were assured that the customer's statements actually were mailed out, and that there were accurate incoming mail safeguards, would you feel that that was perhaps partial assurance of the accuracy of the customers' accounts?

A. Yes; if it were properly supervised, it would be partial assurance.

Q. That is, that would be somewhat similar to a negative confirmation; that is, if you didn't see any objections coming in?

A. That is correct.

Q. To the customers' accounts?

A. Yes.